



9/18/08 - The academics and quantitative analysts spend a lot of time assigning probabilities to market events. For those of you experienced with the lingo, they are measured in standard deviations or sigma events. This is not the time or forum to get into the dirty mathematical details. And I am definitely not the one to explain them!

Essentially, a 5 standard deviation or sigma event is only suppose to occur every 20 or 30 years according to these math geniuses in conventional financial market outcomes. And so many of the Wall Street shops and insurance entities use these calculations to determine risk and amount of leverage to take on.

Leverage is how much money you put up in relation to what you trade. For example, if you have \$100 and you buy \$200 worth of bonds, you have 2:1 leverage.

Events like the Crash of 1929, Crash of 1987, Long-Term Capital in 1998 and so on are all examples of at least 5 sigma events. The problem with these Wall Street and insurance company models is that what is "supposed" to happen once every few decades has now been occurring almost annually. We are now witnessing the second 5+ sigma event in 2008 alone. Clearly, this way of thinking and running a business is severely flawed and will be changed by default.

As I mentioned in Sunday's Street\$marts issue, the end of a decline is where we see the most volatility and price decline. If you roll a snowball down a hill, the ball is the biggest with the most speed the instant before it hits the bottom. The same can be said of the financial markets. They typically decline much faster than they rally, resulting in a cascading waterfall at the end.

We are in such a period right now; one of the most severe in decades. The very existence of the global financial system is being questioned, just like it was during the Long-Term Capital Crisis in 1998 and crash of 1987. Some of you may recall the Hunt Silver Massacre in 1980 as well, along with Penn Central and Continental Illinois.

This is not a stock market crisis like we saw in the bear market of 2000 - 2002. Rather, this a credit and banking problem that has spread to all of the financial markets, including equities. Stocks are pricing in the total shutdown of capital access 3 - 9 months down the road, when the fundamental news will still be bad. During these times, the system becomes disconnected temporarily and the feeling of the world coming to an end overwhelms the masses.

Investors keep asking where the "safe havens" are to invest. In this type of event, the proverbial baby gets thrown out with the bath water and almost everything declines.

Yesterday, we saw more than 90% of all issue on the NYSE go down. Gold stocks were one sector that bucked the trend and I am very glad our gold and spectrum strategies owned this group. But we also owned small pieces of biotech and consumer staples that not fair well.

Time-wise, we are very close to the end, and with so many crosscurrents in place, like end of month, quarter, quadruple derivative expiration and the largest hedge fund liquidation in history, it should be in the next few weeks. In terms of price, it's always very difficult to call since conventional wisdom is thrown out of the window as emotion takes over. It could be today or tomorrow morning down 1-3% or next week down 5-8%. At this juncture, it's pointless to forecast price levels since the markets are not functioning normally.

Over the past 2-4 weeks, we have raised cash levels significantly to some of their highest levels since July 2007. While that helps to cushion the blow, it certainly does not eliminate loss. We began to move money back into the markets yesterday and that process will likely continue over the coming weeks.

Each strategy has its own investment allocation with varying degrees of money market instruments, so it's difficult to give a blanket percentage. Additionally, some strategies have only small maximum allocations to equities, while others can be all equity.

Just like every single other significant decline, we are now seeing signs of extreme or historic readings in the indicators we follow. That forecasts a coming end to the ugliness and major rebound next quarter. Even if the Dow was going to 0, which I am certain it's not, there are always enormous rallies after waterfall declines like this and we are very, very close to one launching from the rubble.

Patience will be rewarded, but emotional decision making is usually punished. Each year, there is typically one great spot to invest that reaps immediate rewards. This may go down as one of, if not the best buying opportunities of the decade. If you have cash on hand, now is the time to que it up for investment in your account or to open a new strategy.

Finally, and perhaps most importantly, as the credit crisis moves on, I am in a heightened state when it comes to where our money is being custodied and which money market funds are being used. Now is absolutely not the time to reach for yield. We should accept a lower yield in money market instruments in exchange for higher quality and better protection. Remember, there is never a guarantee that money market funds will not lose money.

And so, you can expect Heritage Capital to begin consolidating where we custody our accounts next quarter for companies I have the utmost confidence in. You will hear more about this in the coming few weeks.

I urge you not to be complacent with your own banking business. There are many more cockroaches behind the walls! Please contact immediately if you wish to discuss this.

To Your Financial Success,



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