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Asset Management Services
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A Matter of Fact

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Road to Peace

Oil prices have finally come down. From a market peak of \$143 per barrel set on July 6th, Oil closed at \$122 per barrel on August 1st. Such a drop has a meaningful impact to not just the U.S. economy, but the global economy. Companies who use spot prices to fulfill their oil needs, for instance, see immediate savings. While those who use futures contracts for their purchases can lock in lower rates today and protect themselves should prices begin to rise.

But what has caused oil to fall almost 15% in three weeks? One argument is that the higher price of oil was a result of bubble pricing and a “demand shock” due to emerging markets such as India and China (June edition of *A Matter of Fact* argued the case). Another is that a sluggish U.S. economy has reduced consumption leading to a drop in global demand. Yet another is that tension between the United States and Iran has eased in the past few weeks lessening the threat of a military strike by the U.S. and/or Israel.

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Confused Money

Investing can be intimidating even to the most seasoned money manager. For the average investor, sifting through company and economic data, attempting to interpret its meaning and apply it to an investment model is often daunting.

Investors face a double whammy this time as a real estate induced credit crisis has virtually ceased mortgage lending, and soaring commodity prices which have triggered a rapid rise in inflation. Together, the evil duo have caused a sluggish economy and languishing business cycle fueling recessionary level unemployment and weak corporate earnings. One must wonder, “Which shoe will drop next?”

The real estate and mortgage backed securities’ investing bubble finally collapsed last October, and the end of easy access to investor money has brought down big and small companies alike. Pundits, meanwhile, have turned to daily gainers and loser’s statistics, trading volume and charting techniques to “call the bottom.”

Billions of dollars, via loose monetary policy, were once again infused into the economy in an effort to prop up the financial markets and avoid a run on the banks, reminiscent to the Great Depression. Interestingly, monetary policies to combat recession earlier in the decade under the previous Federal Reserve Chairman, Alan “Maestro” Greenspan, were meant to encourage a “soft landing.” The effects of loose monetary policy this go around, though, feel a lot bumpier of a landing than before, as evidenced with several high profile bank failures.

Despite the challenges facing investors, certain events about business and economics cycle hold true. For instance, during a period of rising interest rates, bond holders will see the value of their investments shrink, as newly issued bonds will have a higher interest rates attached to them. Also, as the effects of the latest government stimulus package fade, one could reasonably deduce that profits in consumer discretionary goods will decline.

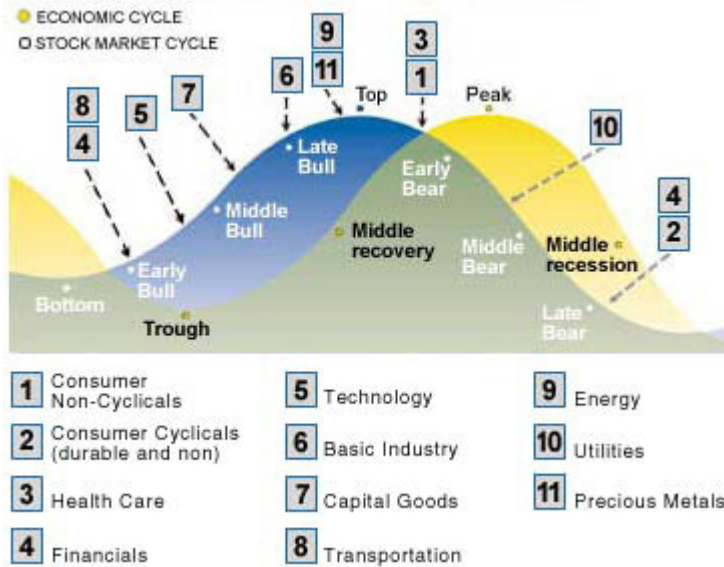
Hence, a tried and true method of forecasting which sectors

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may perform better in various markets is to view the overlap of the business and economic cycle. The graph above demonstrates such a view.

The stock market is a leading indicator and trades at what “it” believes the strength of the economy will be in 6-9 months. Businesses have periods of growth during expansionary economic times, and slow or declining growth during a contracting economy. When viewed this way, we can see that certain equity sectors typically advance at different phases of the cycles. For instance, a strong indicator that a market bottom has been reached is that financials normally lead the stock market and are one of the first to advance during the end of a bear market.

While the financial sector has taken a severe beating in the past year for its role in the current credit mess, they managed to lead two back-to-back market rallies in July. One of our favorite banks, Bank of America (Ticker: BOA), traded at a low of \$18 per share on July 15th, and soared 72% to close at \$31 on July 23rd.

So, does this mean that we are indeed in the late phase of a bear market and financials are indicating better days are just 6-9 months away, or is this another false signal?

Xerxes is not as sanguine in the latest rally as other forecasters. To us, the downdraft in bank, discretionary (consumer cyclical) retail, health care and technology sectors suggest that we are somewhere between early and middle bear line on the cycle. Bucking this trend so far has been the transportation sector. The surge in oil and fuel prices has not derailed them from posting gains for the year. The IShares Dow Jones Transportation Index (Ticker: IYT) is up 11% year to date as of August 1, although it has given up over half of its 23.75% gain it reached on June 5th.*

Perhaps more important to individuals is what exactly does this mean for your investments? It is our opinion that it is rational to be invested in the stock market under today’s conditions as part of a well-designed investment plan. The normal dangers of over-valued stocks, fast moving events and other uncertainties exist, as always, but the ability of stocks to weather inflationary and deflationary environments make them a compelling asset class for many investors (See side article, “Cliff Notes to Investing”).

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<u>Stage:</u>	<u>Full Recession</u>	<u>Early Recovery</u>	<u>Full Recovery</u>	<u>Early Recession</u>
Consumer Expectations	Reviving	Rising	Declining	Falling Sharply
Industrial Production	Bottoming Out	Rising	Flat	Falling
Interest Rates	Falling	Bottoming Out	Rising Rapidly (Fed)	Peaking
Yield Curve	Normal	Normal (Steep)	Flattening Out	Flat/Inverted

Confused Money (continued)

Even though we are not “officially” in a recession, most people would agree that the current state of the U.S. economy is far less healthy than the “official” numbers suggest. Stagflation—an inflationary time with declining asset prices—also should not be ruled out quit yet. History will finally tell us whether this was a period of recession or stagflation, and its severity.

The economic landscape has shifted decidedly. While speculators and active traders may find short term opportunity in the current environment, we will continue to be selective and invest based on sound finance and economic principals—the only method which has consistently withstood the test of time. Regardless of the economic environment, at Xerxes our question remains, “Where will the healthy profits come from?” **XFG**

* SOURCE: Yahoo! Finance



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Road to Peace (continued)

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While the first two arguments have a significant impact to global oil demand and prices, the last point is perhaps the most compelling and worth discussion.

“...silence critics on America's foreign policy...”

Many people would like to think that the Bush Administration's new stance in using diplomacy to engage Iran would lead to a mutually beneficial result. But, some argue that it is the Administration's way to legitimize a military strike against Iran in the last months of Mr. Bush's presidency.

No one outside of the closed door meetings between top U.S. Administration Officials and members of Israeli Officials know for certain the reason of the sudden change in policy. But two things are certain: 1) a friendly Iran could have a positive influence with troubles in Iraq and Afghanistan, as well as Hezbollah—Israel's arch enemy and 2) an attack on Iran—even if spearheaded by Israel—would cause further resentment to the U.S. and wash more Middle Eastern troubles to our shores.

In recent weeks, tensions have risen between Iran and Israel, with Israel conducting aerial war games demonstrating its abilities to attack, and Iran responding by carrying out long-range missile tests to show its ability to reach Israel from its own borders.

These moves, we hope, are more psychological than a call to war. If an attack on Iran is imminent, it will likely come from a surprise “shock and awe” strategy and not telegraphed in advance. Also, the U.S. would have to give its consent to Israel to use its bases in the region. Doing so would drag the U.S. into a yet another conflict with potentially far greater consequences.

Iran, meanwhile, has also declared that an attack on its nuclear facilities would cause it to destroy or otherwise damage the Straits of Hormuz in the Persian Gulf where 40% of the world's oil supply passes. If this threat becomes real, it would likely cripple the global economy and bring about a global recession (even depression) the likes of which has not been seen.

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Road to Peace (continued)

“A friendly Iran,” however, would not only substantially drive down oil prices, but would likely help U.S. efforts to bring stability to Iraq and allow us to begin bringing our troops home—a very desirable result for the Administration.

Establishing commerce and a trade partner to a nation that is quick to embrace American goods and services has many advantages. Some 70% of Iranians are under age 35; many are college educated and speak English; high unemployment of about 20% cause low wages. Integrating Iran into the western world could be done in a relatively short period of time with long lasting benefits. Both nations would benefit tremendously economically and politically.

But this is not an argument to treat Iran as a profit center. Rather, it is to seize an opportunity and treat it as a source of potential stability in the region. Restoring diplomatic ties between the two nations will not be easy and is fraught with risk. Both Iran and the U.S. have leverage over one another. At the end of the day, both would like to claim victory and not appear desperate or weak.

Many attempts have been made to restore (or introduce) peace in the Middle East during the Clinton and Bush Administrations. When we consider why past efforts have failed to bring about desired results, we can not help but notice Iran’s absence at the table during peace talks. Perhaps the road to peace is through Iran.

The current opportunity presents a potentially tremendous solution for U.S. foreign policy and the broader Middle East. Restoring diplomatic relations with Iran could arguably be the most important step to lasting peace in the Middle East with Iran playing a meaningful role.

If level heads prevail and diplomacy wins, it will help close the final chapter of George W. Bush’s time in office with a successful end to the Middle East conflict. Such a measure could help silence critics of America’s foreign policy and pave a path of continuous diplomacy as the primary choice for the next President to occupy the White House.

Let’s hope so. *XFG*

Vital Signs

<u>Year</u>	<u>Dow Jones Industrial</u>	<u>S&P 500</u>	<u>10 Year Bond Yield</u>	<u>Inflation</u>	<u>National Unemployment Rate</u>	<u>Fed Funds Rate</u>
2008						
July	11,378	1,267	3.98	—	5.7	2.01
June	11,350	1,280	3.98	5.02	5.5	2.00
March	12,262	1,322	3.43	3.98	5.1	2.61
2007	13,264	1,468	4.63	2.85	4.6	5.02
2006	12,463	1,418	4.80	3.24	4.6	4.97
2005	10,717	1,248	4.29	3.39	5.1	3.22
2004	10,783	1,211	4.27	2.68	5.5	1.35
2003	10,453	1,111	4.01	2.27	6.0	1.13
2002	8,341	879	4.61	1.59	5.8	1.67
2001	10,022	1,148	5.02	2.83	4.7	3.88
2000	10,788	1,320	6.03	3.38	4.0	6.24
1999	11,497	1,469	5.65	2.19	4.2	4.97
1995	5,117	616	6.57	2.81	5.6	5.83

Source: Dow Jones, S&P, Freddie Mac, Federal Reserve, and Wall Street Journal, Bureau of Labor Statistics .

Cliff Notes to Investing

So far in 2008 we have seen the major indices continue their downward spiral which began in October 2007. In June we witnessed the DOW Jones Industrial Average actually closing below 11,000 and the S&P 500 reaching a low of 1,214. The markets have recovered 3.8% and 4.3%, respectively, off of these lows with some truly impressive back-to-back rallies led by financials. Encouraging news for short term traders and speculators, but long term investors should use such conflicting market movements as a time to sell in the strength, and buy conservatively financed companies during a retraction.

It is easy to understand that most investors want to stay in the market to earn back losses, but the choppy market conditions along with the uncertain economic outlook have added substantial risk considerations to just about everyone's investment portfolio. The thought of significant, additional losses is distressing and compounds the anxiety many feel.

Further feeding everyone's fear is the jobs market and outlook on unemployment. In our previous newsletter we stated that "...the likely hood of a continuous rise in unemployment seems almost certain for the next few months at least." Data released at the time of this writing shows that unemployment rate has gone up to 5.7%, which is just shy of the annual rate of 5.8% set in 2002—a period of recession.

Meanwhile from the best economists at the money center banks to our own Federal Reserve, all are busy restating their outlook to a paltry 1-2% growth for the next 12 months and just about everyone including the Federal Reserve feels there is substantial risk of continued weakness, i.e. recession, inflation, stagflation. So which is it, growth, recession, inflation or stagflation? More importantly, how do you invest in this environment?

Most people think of investments as stocks or bonds, with stocks carrying more risk than bonds. While that may be true, there are situations where bonds could carry more risks than stocks. For instance, if the economy doesn't falter and corporate earnings recover a little bit, history tells us that the stock market will jump on anticipation of further good results. Those who are fully exposed to stocks will get maximum benefit from this trend and earn some good gains while bond holders will likely see relatively meager returns—especially in a rising interest rate environment.

But, as we have learned, the markets are not so clear

cut. The key is that active management and adequate diversification will likely yield better results regardless of the multi scenarios we face.

The reason for our confidence is that stock market declines have brought valuations of some really good companies to a level where you can buy and wait with confidence in the fundamentals. Today's price and business fundamentals are in balance for a number of good companies and you can buy with confidence that your investment will pan out with time.

Here are the rules and quick ratios we use for investing in this slippery market, followed with brief explanations.

- Balance.
- Cash.
- Price.
- Franchise.

Every year, or more frequently if market conditions suddenly change, you must balance your portfolio. Even well diversified portfolios may have become "top heavy" due to substantial gains on some positions—or, yikes!, substantial losses in another. Having a conservative bond portfolio will do wonderful things for your investing. It will diversify your holdings reducing volatility, give you a ready source of liquidity to buy when stocks are cheap and it will force you to take gains off the table through rebalancing.

"Cash is king" is a phrase you hear a lot during tough times. To us, its meaning is two fold: 1) it means that conservatively financed companies can weather bad times without being forced to resort to desperate measures to survive and 2) cash provides stability to investors' portfolios during choppy market conditions and allows them to buy companies with good earnings at a discount.

Conservatively financed companies have lots of tangible equity and don't have hidden financial problems, i.e. assets excessively tied into real estate and/or mortgage instruments, or off-balance sheet time bombs. These companies can tap their balance sheet strength to buy up good assets from distressed sellers, a la J.P. Morgan and Bear Stearns.

Once a conservatively financed company is identified, the next component is price, and it involves three steps. First, look at the company's price and be reasonably certain that the price reflects its future value. There are many ways to value stocks, but we like to use comparable value.

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Cliff Notes (continued)

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Here, the price and earnings of the stock is compared to its peers. This method is a fast and good approximation to gauge a companies short term prospects. Beware, though, comparable value could leave an investor open to bubble pricing.

The second part of pricing is to figure out how many years it will take the company to earn-back what you pay. For instance, if you pay \$40 a share and the company earns \$3.60 per share each year, then it will take the company about 10 years to earn back your purchase price. Most companies' earnings grow a little year-over-year so it may reduce the earn-back to 6-8 years. Be very suspicious of any stock that requires more than 12 years for payback because that is about the same time it takes to recover your cost basis in a risk free investment, such as U.S. Treasuries.

Finally, many professional analysts use discounted cash flow models to value companies. The precise valuations of cash flow analysis are based on time value of money, but this technique is built entirely on estimated numbers and small changes in assumptions can swing the result wildly. Nevertheless, using ultra conservative assumptions in calculating discount cash flow is a very useful tool for investing.

As long as you pay a reasonable price and the company performs, you will have made a successful investment. But what if the company does not perform? This brings us to the final investment principle – franchise.

It may surprise you to hear this in tough times, but most good companies continue to be profitable. Whether times are good or not so good, Toyota makes a lot of money selling cars. Microsoft makes billions delivering software. Exxon-Mobil makes a ton of money each year doing virtually the same thing it did sixty years ago. That is franchise!

Other well known examples of world class franchise include Kraft, Coca Cola and Proctor & Gamble. Less obvious companies, too, have world class franchise that could be overlooked – but should not. Brands such as Johnnie Walker, Captain Morgan and Tanqueray are owned by Diageo Plc (Ticker: DEO) of the United Kingdom.

DEO's stock price has fallen from a high of \$93 set in November 2007 to \$69 currently. While such a drop may

be justified, still, DEO has a 5 year anticipated growth rate of about 10%, a dividend yield of 3% per annum, an earn-back of 8-10 years make it a franchise worth serious consideration. Even using conservative discount cash flow model, present value of this stock is about \$80.*

So there you have it. If you buy a conservatively financed company with a good franchise and you pay a reasonable price, you can hold stock in today's market and sleep peacefully. The best thing is that if the market starts to pop again and valuations rise then you will be positioned to enjoy that out performance. On the other hand if the stock market slops along, you can count on the earnings of your businesses to create the value you are looking for through their earnings.

There is a further extension of this strategy, but it is not suitable for most people. The same analysis that reveals a good stock to buy also tells you which stocks are over-priced. Hedging your portfolio by taking some short positions can reduce the downside if the overall market falls in the short term. We do not recommend that you do this type of investing on your own unless you have a clear understanding of the risks involved. Protective puts, however, is a premium paid and acts as an insurance policy in the event of a catastrophe.

The lower the overall market goes, the more companies there will be that meet the equity, price and franchise tests. Have a qualified professional go through your portfolio and throw out the losers, the ones that cannot pass these tests, then stuff in stocks that do. If the idea of selling at a loss does not sit well with you, consider this: if you replace your positions with more attractively valued stocks, you are still in the market—hopefully better positioned to enjoy the ride up. *XFG*

Announcements

We hope that you have enjoyed your summer with friends and family. Before the summer draws to a close, we wanted to update you with what has been going on at Xerxes.

- Ismail Laher, XFG's Compliance Officer, has successfully passed his Uniform Investment Advisor Law exam (Series 65) over the summer, adding to his list of credentials.
 - We are planning a client dinner seminar sometime in September. We extend the invitation to others you feel may wish to attend. Details to follow in separate mailing.
 - If you know of any financial professionals who might be a good fit with Xerxes, we would like to talk to them. We look forward to seeing you soon.
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