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Xerxes Financial Group, Inc.
9554 Old Keene Mill Rd,
Suite G
Burke, VA 22015
703-913-7701
www.xerxesfinancial.com

Asset Management Services
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Employee Benefits

A Matter of Fact

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Ray of Hope

The U.S. stock markets reached their peak in October 2007 and have been on a decline ever since, albeit with several short lived rallies. With three quarters of 2008 now behind us, the Dow Jones Industrial Average is down more than 18%, and the S&P 500 is down greater than 20% year to date.

During such troubled times, how can anyone be optimistic? The answer may rest with oil prices. High priced oil is a familiar enemy. Filling gas tanks and winter heating while crude oil continued to rise to its peak of \$147 per barrel are painful to our wallets. Not only do higher energy prices sap consumer buying power, it aggravates our trade deficit and increases the likelihood of a weaker dollar.

Currently, oil trades around \$95 per barrel, down about 35% from its mid July peak. The net result of such a steep drop in price is a savings of over \$100 billion that would have gone toward energy costs could now be used differently.

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In Search of Stability

Pundits for the \$700 billion plus Financial Rescue plan hope to calm stock markets with its passing, and use tax payer dollars to buy “unmarketable” securities to help facilitate economic growth. Ultimately, the likely outcome of the bailout will lead to the tax payers being forced to forgive a hand full of executives and reward them by maintaining their lifestyle, while the unassuming borrower/investor/average Joe is financially drained and emotionally defeated. The old saying, “Players get fired before the coaches,” comes to mind. Furthermore, for the bailout package to work requires the cooperation of many of the institutions who played a role in getting us in this mess.

If history were to describe the “W” era of presidency with one word, it should fittingly be “unprecedented.” From Mr. Bush’s controversial election win in 2000, to the Bush Doctrine and the seemingly weekly bailouts of late, this administration is riddled with a series of firsts. Before a new president occupies the White House, we should not be surprised if an “unprecedented” volume of Presidential Pardons are handed out.

The catalyst to getting the economy moving again is not the Plan that is before Congress. To unfreeze the credit market, businesses that hold troubled real estate and/or mortgage paper should be encouraged to write down those assets to better reflect real world assessments. Simultaneously, regional level property reassessments, coupled with proportionate debt refinancing would reduce the burden on the debt laden consumer. See chart 1.

The question, then, is who picks up the tab? The cost of such a plan can be measured in different ways. But the bottom line is that the actual cost would be spread out among consumers, business and government.

The bottom line would translate to businesses getting tax benefits as result of their cooperation, with the ability to “carry forward” those losses for future years. Also, consumers would have to pay lower property taxes due to the reassessments, thereby lessening their monthly obligation of homeownership. Logically,

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In Search of... (continued)

Chart 1

	<u>Current</u>	<u>Reset</u>
Home Value	\$450,000	\$225,000
Mortgage	440,000	220,000
Monthly	3,200	1,600

the government would collect less tax revenue from consumers, and give more tax credits to businesses, but would benefit and recover its “loss” from ongoing economic expansion and tax receipts.

According to the Federal Reserve Board (Fed) the aggregate size of the U.S. mortgage market is \$14.8 trillion. The residential portion accounts for \$11.3 trillion which includes both prime and sub-prime mortgages.

While that is a staggering amount, not all mortgages are troubled. For the sake of argument, we will assume that “troubled” mortgages include current delinquency and foreclosure rates, as published by the Mortgage Bankers Association, along with those that are in the legal process of foreclosures. When viewed this way, the total residential mortgages in trouble are approximately \$1.1 trillion, or 10% of total residential debt outstanding.

Supposedly, the \$1.1 trillion is the cause of the market’s malfunction. The proposed \$700 billion bail out is to acquire “troubled” papers (the math works out so that tax payers are buying the debt at around 65 cents on the dollar), and unclog the “bottle neck” to allow the more marketable securities to function. The eternal optimists argue that once the market begins to move, the government will sell the assets for a gain.

When the current bailout is compared to the solution outlined above, it is easier to see that focusing on the two causes of the financial crisis (mortgages and real estate values), will give the market traction much quicker. Also, such an event will prevent more job loss, create immediate opportunities for competition to take root, drive out weak and financially irresponsible companies and still hold corporate executives accountable.

Whether a 50% write down or some other amount, such a plan would serve businesses and consumers well by helping the economy gain traction once again, providing the consumers debt relief and avoid affecting other sectors of the economy. Although the above is oversimplified, it is certainly worth serious debate.

XFG

Hold That Buck

The mortgage crisis that spread like wild fire in the final quarter of 2007, quickly gave way to a financial crisis by March 2008. Bear Stearns’ breath taking collapse provided an early indication of things to come. Once the country’s fifth largest investment bank, it was ultimately acquired by J.P. Morgan – with the support of the Federal Reserve – for pennies on the dollar. Talk of “that was close” and “the worst is over” helped spark a rally after the fire sale.

The ensuing rally proved to be short lived and the mortgage crisis quickly turned into a crisis in confidence. By June it became clear that banks and investment banks alike had little confidence in each other’s paper assets, causing the credit market to come to a screeching halt.

The complex agreements financial institutions such as Bear Stearns, Lehman Brothers and AIG had with other financial institutions created a tightly knit web so interconnected that would sink even more financial institutions as a result.

While the list of high profile financial institutions will likely grow, including more banks, the immediate concern for most people should be the safety of their money market and daily cash accounts held at banks and brokerage houses. Specifically, the “papers” that back the cash accounts.

To begin, they should take a look at their money market accounts (at the bank or in their investments). Believe it or not, anything paying over 1% annually should be suspect. Here is why.

Money markets are seen as safe havens that provide stability, and a one-to-one per share parity, as many investors

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Hold That Buck (continued)

(or depositors) “park” their cash in such accounts. By law, money market accounts must only invest in short term securities and commercial paper (i.e. iou’s) of top rated financially strong institutions. But as we now know, when these fine institutions begin experiencing financial distress and asset deterioration, they get downgraded by rating agencies which force holders of their debt to sell (often at a loss) as the issuing companies no longer pass the “top rating” test. Naturally, a wave of selling ensues further exacerbating and devaluing the net asset value. This rare but real event is commonly referred to as “break the buck,” a term so coined when the net asset value of a money market account falls below one dollar.

How can an investor know what their money market fund holdings are, you may ask? Their holdings are disclosed in the Annual Report mailed to share holders every year. The problem, though, is that while many investors do not scrutinize such documents, brokers should as they have been entrusted by their clients to protect their interest and “manage” their wealth.

What about FDIC accounts, you may ask. Here the rules are in the customer’s favor. The Federal Deposit Insurance Corporation insures member bank’s customer accounts up to \$100,000 per depositor, per insured bank. Owners of some retirement accounts are insured up to \$250,000 per owner, per insured bank.

It is important to note that deposits held in separate branches of an insured bank are not separately insured. Deposits in one insured bank are insured separately from deposits in another insured bank. That is, if a customer has \$200,000 in two separate accounts identically registered at the same insured bank, then only 50% of their deposits are insured. The full amount is insured only if the accounts are less than \$100,000 and held at different insured banks.

“...the immediate concern ...should be safety of ...cash...”

In 2003 the Certificate of Deposit Account Registry Service (CDARS) was formed to help banks in their network to ensure FDIC insured accounts up to \$50 million. Banks who have signed on to this network may accept deposits larger than the FDIC limit.

CEDRS then distributes the total deposit in denominations below the FDIC limits at multiple banks. The customer receives the convenience of one statement, one interest rate and the security of FDIC insured coverage up to \$50 million. More information may be found by visiting www.cdars.com. **XFG**



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Ray of Hope (continued)

Well known is that the U.S. is a nation of consumption. In fact, each time past business and economic fundamentals showed signs of stress since the millennium consumer spending spearheaded our recovery and prevented the economy from sliding into a recession much earlier.

By now each of us is intimately aware of the credit crisis and its effect on the debt riddled consumer. As fuel costs rose, consumer disposal income dwindled, affecting other industries. Macy's (Ticker: M), for instance, started the year at \$26, and trades at \$18, a decline of 30% as of September 30. Bucking the trend is Target (Ticker: TGT) which is essentially flat at \$50, and Wal-Mart (Ticker: WMT) which is up 25% for the year.

The positive consequences of high energy prices and a slowing economy, though, are that consumers have made adjustments to their appetite for energy, and the slowing economy puts downward pressure to the price of oil. As we discussed earlier, fuel prices are down over 30% from their peak. This translates to roughly \$100 billion of rediscovered disposable income for the

consumer. If so, this would suggest much needed good news in the headlines with a spike in retail sales in the coming months.

Alternatively, doubters argue that consumers are "tapped out" and that disposable income, if any, will likely be put into savings or used to pay down debt.

But even the last two scenarios would help the economy. The estimated \$100 billion plus that would be saved in energy costs would end up at banks that are, by some measure, even more "tapped out" than consumers. Banks in turn would suddenly have more sorely needed funds available for lending at a time when credit is scarce. **XFG**

Announcements

We appreciate the referrals clients have provided.

- Archived *A Matter of Fact* newsletters can be found on our website, xerxesfinancial.com under "Newsletter". Visitors must call us for Username and Password.
- We continue to actively search for experienced financial professionals to bring on board. If you know of any financial advisors who might be a good fit with Xerxes, we would like to talk to them.
- Please call to schedule a portfolio review before year's end.

We look forward to seeing you soon. **XFG**

Vital Signs

	Dow Jones <u>Industrial</u>	S&P <u>500</u>	10 Yr. Bond <u>Yield</u>	<u>Inflation</u>	National <u>Unemployment Rate</u>	Fed Funds <u>Rate</u>
2008						
September	10,851	1,165	3.8	4.8*	6.1	2.00
June	11,350	1,280	4.0	5.0	5.5	2.00
March	12,263	1,323	3.5	4.0	5.1	2.61
2007	13,265	1,468	4.6	2.9	4.6	5.02
2006	12,463	1,418	4.8	3.2	4.6	4.97
2005	10,718	1,248	4.3	3.4	5.1	3.22
2004	10,783	1,212	4.3	2.7	5.5	1.35
2003	10,454	1,112	4.0	2.3	6.0	1.13
2002	8,342	880	4.6	1.6	5.8	1.67
2001	10,022	1,148	5.0	2.9	4.7	3.88
2000	10,788	1,320	6.0	3.4	4.0	6.24
1999	11,497	1,469	5.7	2.2	4.2	4.97
1995	5,117	616	6.6	2.8	5.6	5.83

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