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Newsletter
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The world events continue to unfold at warp speed. Notwithstanding the continuing news, there are some positive signs and the economic free fall seems to be slowing its rate of decent. As we stated in our January paper, "Sea Change", we expected the free fall would end, the economy would bottom, there would be a recovery and then the world would move to a new equilibrium, but at a lower level than before. The unknown was the details of ending the plunge and then what the world would be like once we get through this and return to some level of stability. We continue to believe it will be quite different from where we were. Some of the changes coming into focus include: The government having a much larger role in running the economy: Higher taxes; A shift away from consumerism to more savings and; Emphasis on more equal income distribution. Globally we also see huge changes. Protectionism and de-globalization have started. The "Financial Times" has been running a series on the "Future of Capitalism" which has been excellent reading. One of its recent forecasts was: "The coming 20 to 30 years will be the era of the US and China." Investors are trying to deal with these uncertainties and changes which are driving the market volatility. This will certainly continue. Risk, control and protecting what you have accumulated have taken on new emphasis.

The government continues to pull out all the stops to solve our and the rest of the world's economic problems. Returning the credit markets to some level of normality remains its top priority. Although some companies have already written off staggering amounts of debt, we are bothered by the lack of consensus on how to write off the rest. Hiding it and failing to clean up our balance sheets will delay a strong recovery. A growing concern is how we will eventually pay for these government programs.

What will the economic recovery look like? This is conjecture but one possible scenario is a sharp recovery caused by a snap back from the steep slide as consumers and businesses spend pent-up demand. The government stimulus programs could provide an additional kick. But it is what happens afterwards that is important. "The Bank Credit Analyst" argues the economy might have a "W" recovery with the economy after its initial recovery dropping into a second recession as the Federal Reserve backs off its easy money policies and the fiscal stimulus programs run out. Life will not be simple. The stock market as measured by the blue chip averages has rallied an impressive 25 percent from its recent lows. It still closed down -11.7%, as measured by the S&P 500,

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for the first quarter. The rally could extend from the current levels while the market still remains in the basic down trend that has been in place since October 2007. A lot of bad news is still likely to come out. We don't know whether this will drive the stock market to new lows or whether investors have already priced it in, meaning the existing lows hold. The bulls and the bears are battling for control.

Over the last year investors have been reevaluating their tolerance for risk, frequently deciding it is much less than they thought. We view "risk tolerance" as the investor's psychological ability to deal with the volatility. How much can a portfolio drop before you can not sleep at night? Another useful but different concept is "risk capacity". This deals with whether somebody can *afford* to lose assets. Risk capacity is quite different than risk tolerance. Somebody with a million dollar portfolio who is close to retirement and needs the portfolio to provide \$40,000 of income may not have the capacity to lose much value which would threaten the portfolio's income producing capacity and the retiree's lifestyle.

Over the last year we have adjusted investment strategies and made portfolios more conservative. We believe it is different this time. Investment strategies should be changed to reflect this. Our approach is different from that of many advisors. The national and global changes we identified in the first paragraph are too important to ignore.

The future is particularly uncertain and there is a wide range of possible economic outcomes. We think portfolios should be structured to reflect this uncertainty. Investing is about more than just stocks (note how everybody asks how the stock market is doing), and we need to spend more time analyzing other investment vehicles. Stocks historically have done well with low inflation and a growth environment, but have done poorly in periods of slow economic growth, recessions, or high inflation. All of the latter are possible in the future. Thus, we need to include in portfolios investment vehicles that have potential to do well in other economic scenarios.

The uncertainty takes us in another direction that is different from many other advisors. People frequently ask what is the probability of something happening and they want to invest their portfolio to benefit from the most likely scenario. "I think the market has bottomed" is a view that encourages an investor to allocate more stocks. The possibility of a low probability event occurring (the market drops steeply from current levels) that causes a devastating impact on an investor's portfolio needs to be taken into account. For those of you following what has happened on Wall Street, ignoring low probability events is similar to the managers who ignored the impact of "tails", low probability events, that when they occurred led to huge losses.

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