



**Zemenick &
Walker, Inc.**

Market Perspectives

An Independent Investment Advisory Firm, Established 1987

Fall 2007

Zemenick & Walker, Inc.

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Anatomy of a Housing Market Collapse

The U.S. Census Bureau reports that from 1990 through 2000, the median sales price of new homes in the U.S. increased by an average of 3.2% per year. Yet from 2000 through 2005 that rate of growth jumped to 7.4%, with the median sales price of existing homes increasing by almost 9.0% annually according to the National Association of Realtors. With interest rates falling, it is not surprising that home equity quickly became an inexpensive and easy source of capital for many.

The kindling for the housing surge came in the search for a safe alternative to stocks following the tech crash of 2000. With the stock market devastating investment portfolios and the Federal Reserve moving aggressively to cut interest rates in 2001 and 2002, many investors saw an opportunity to invest in residential real-estate, often through a process called “flipping”. Additional fuel was added through the increasing availability of mortgages to “subprime” borrowers—those borrowers with credit scores below 620. According to the Office of the Comptroller of Currency (OCC), subprime mortgages have historically represented 10-12% of the total mortgage market. However, over the past two years subprime originations have risen to over 20% of all new mortgages. On the positive side, subprime mortgages have made home ownership a reality for many who otherwise would not meet the qualifications of more traditional lending standards. This translated to increased demand, and had been one of the driving forces behind our nation’s recent economic prosperity. Yet as beneficial as it was, problems are now surfacing which threaten that very prosperity.

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Zemenick & Walker Relocates to New Office

We moved to our new office location, 8182 Maryland Avenue, Suite 200 in the Clayton Financial Center building on September 21st. Upgraded phone and computer systems, larger conference rooms and employee work areas, and room for future growth are a few of the benefits of the move. The new office is just two blocks from our previous building and is located on the north leg of the Clayton Triangle, which is bounded by Maryland Avenue, Forsyth Boulevard, and Brentwood Boulevard. A fourteen story parking garage services the Triangle, with convenient access just east of our building from Maryland Avenue. Pull in through the security gates and look to the left for Zemenick & Walker, Inc. reserved client parking spaces. Please be sure to bring your parking ticket inside for validation.

As mentioned above, concurrently with the move we installed a new phone system that allows for direct dial to each employee. Of course, you may continue to reach us through our main number. For those who want to use them, direct lines are included in the following phone directory:

Zemenick & Walker Phone Directory

| | | | |
|--------------------------|-----------------------|----------------------|-----------------------|
| Main | (314) 862-5525 | Fax | (314) 862-6165 |
| Toll Free Main | (866) 261-0120 | Toll Free Fax | (866) 261-4180 |
| Chris Griesedieck | (314) 880-4861 | Denise Suria | (314) 880-4867 |
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Patience Pays off with Top Fund Managers

“To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks.” ~ Benjamin Graham

Consistently superior results are hard to achieve in just about any aspect of life. But as value investing pioneer Benjamin Graham points out, it can be particularly difficult in the investment arena. The first part of his statement helps explain why so many different mutual funds exist - over 8,000 alone in the U.S.! The second part helps explain why only a small minority of mutual fund managers are able to beat their benchmark year in and year out. In fact, nearly all of the managers who outperform in the long run have extended periods of time where they do not. This reality helps emphasize how misleading short term returns can be. The truth is that all mutual funds will trail at some point in time; investors' patience with a manager can be as important as investors' confidence in them.

Manager returns, for better or worse, play a major role in the mutual fund selection process. Quarter to date, year to date, 1,3,5,7, and 10 year returns are all telling aspects of a fund's performance. But how much significance does each one have? One year and shorter returns give an indication of how well a fund is doing in the current market environment, but they certainly do not tell much of a story. In fact, an excellent study by Litman Gregory argues that true long term performance should really be measured by a 10+ year figure. The point of the study was to show that nearly 100% of mutual funds that outperform their index for a ten year period actually lag that same index for over three of those years. This article will not only explore that study, but also look to apply it specifically to the mutual fund selection process.

The phrase “hindsight is 20/20” is only partially true when it comes to returns in the mutual fund world. Investors often times look at a manager's ten year return and think to themselves “why didn't I buy this fund ten years ago?!” In actuality, there are probably plenty of investors who sold that same fund years ago due to underperformance and now think, “why didn't I stay invested with them?!” That rolling ten year return may show great performance, but what it will not show often times is that the fund underperformed for several consecutive years, for multiple time periods, or both. It will not show that the fund probably had many highs and lows in that time span and that the only way to attain it's stellar ten year return was to be patient and confident in the fund.

The Litman Gregory study mentioned earlier sought to analyze just how patient those investors need to be. After screening the mutual fund universe for an appropriate sample set, the researchers then selected only those mutual funds that outperformed their respective benchmark by more than 1% annualized over the past ten years. From there, they closely examined annual returns for the funds in comparison to their benchmarks. The results were fairly surprising. They found that 100% of large cap value and small cap value managers, and over 88% of growth managers, lagged the index by over 2% annually for more than three years in the midst of a ten year stretch of outperformance. Taking the study a step further, they looked at what percentage of funds lagged by more than 5% annually for a three year period. Over 71% of growth funds and 50% of value funds did! The last finding to be pointed out was that almost half of all small cap blend funds (mix of value and growth) underperformed their index by 10% annualized over three years. Imagine watching your investment trail an index by 10%+ annualized for three years only to see that after ten years, it had beaten the benchmark. That is patience!

As an investor, it is important to invest in future returns, not past ones.

This study teaches us several things. First off, short term returns, even three year returns, give little indication of a manager's long term potential. Thus there is no basis for picking funds based on recent returns. Another similar study by Mercer Investment Consulting found that “excellent performance in the initial period (top quartile for 3 years) generally leads to *underperformance* in the subsequent period.” The Litman study also shows that even the best actively managed funds can't outperform every year. Manager returns are going to substantially exceed or fall short of their benchmarks quite often. The fact that almost 100% of “good” funds underperform for three years shows that investors need to stick around for those periods of outperformance.

One last thing to take away from this study is that historical returns by themselves, short or long term, do not make a compelling argument for investing in a mutual fund. They can obviously be misleading. As an investor, it is important to invest in *future* returns, not past ones. A short list of key aspects to research include: manager(s) background, tenure, and investment style, as well as the fund's expense ratio, risk/volatility, front end or back end loads, size, turnover, etc. This research should help investors gain confidence before investing and should make patience while invested, a much easier practice ■

Z&W Ranked #1 in Missouri in 2007 Wealth Manager Survey

We are proud to announce that Zemenick & Walker ranked 40th in the nation and 1st in Missouri in *Wealth Manager* magazine's 2007 “Top Dog” survey of independent investment advisory firms. The magazine ranked registered investment advisory firms who also provide financial planning services (this excludes banks, broker/dealers, and trust companies) based on size of average client relationship. This was the magazine's seventh annual survey in which they ranked 464 firms from around the country. We thank our many clients and friends whose support has made our success possible ■

Recently Obtained Professional Credentials

Congratulations to Bryan Schulz and Jonathan Best for becoming Certified Financial Planner™ professionals as they recently passed the CFP exam - a 10 hour exam covering the core areas of financial planning: insurance, investments, tax planning, retirement planning, and estate planning. The knowledge gained in the exam process is critical to tackling the financial planning issues that we encounter with clients on a daily basis.

In addition, CFP® certificants must abide by CFP Board's Code of Ethics and Practice Standards, requiring them to act in the best interests of clients and to act in accordance with the highest ethical

and professional standards. They must also complete continuing education credits to maintain their level of professional expertise.

We also congratulate Jonathan on earning the CFA® designation - a globally recognized credential for investment analysis and management. Recipients of the CFA charter have successfully completed a graduate level, self study curriculum and three rigorous examinations. The exams cover ethical and professional standards, securities analysis and valuation, financial statement analysis, quantitative methods, economics, corporate finance, portfolio management, and performance measurement ■

Anatomy of a Housing Market Collapse

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For example, many of the mortgages written for subprime borrowers have been of the non-traditional type, which typically offer lower interest rates up front than traditional mortgages. In fact, First American Financial reported that between 1998 and 2006, adjustable rate mortgage (ARM) loan originations increased from 0.7% to 69.5% of all mortgages underwritten. While the low interest rates helped buyers secure housing initially, homeowners are increasingly facing a painful reality. The Mortgage Banker's Association estimated that some \$1.5 trillion in ARM loans are scheduled to reset in 2007 alone, with even more scheduled for reset in 2008. Assuming higher reset rates, and housing prices faltering, struggling homeowners have few options. Consequently, foreclosures and delinquencies have skyrocketed, with the Center for Responsible Lending estimating that one in five existing subprime loans will end in foreclosure.

While it is still much too early to predict the long-term economic impact of the subprime meltdown, reduced consumer spending, tightening of credit, and a slow-down in construction will undoubtedly keep Fed policy makers on their toes. At the same time, the subprime meltdown has sent shockwaves through the financial markets over the past six months.

The root of the problem is quantifying the true extent of subprime risk in the market. Even former Federal Reserve Chairman Alan Greenspan admitted in a "60 Minutes" interview recently that he was caught off guard by how damaging the growing subprime market could be. Much of the problem lies in transparency, which up until the 1980's was never an issue, as banks typically held home loans on their own books. Thus, conservative lending standards were paramount. However, thanks to deregulation and the advent of structured finance in the 1980's, mortgage lenders rarely hold loans on their books anymore. Instead, most lenders now sell their mortgages to wholesalers such as large Wall Street banks. Here, these loans are packaged, stamped by a credit agency (i.e. Moody's), and sold to institutional investors such as mutual funds and hedge funds. Through this process, the ultimate creditor risk is transferred not once, but twice from the mortgage originator to the investor. Moreover, many of the credit agencies that rated these securities were consulted in their very formation -

a conflict of interest according to many. Some critics are even comparing the role of the credit agencies in the subprime meltdown to the role played by many accounting firms in the corporate scandals of a few years past.

Unfortunately, many investors seeking the high yields offered by mortgage-backed securities and relying on their high credit rating plunged into these investments not fully understanding their risks. Naturally, as demand for these murky investments grew, pressure on mortgage originators to increase their volumes also grew. With risk effectively eliminated for the originator, you can guess what happened next—increased use of non-traditional mortgages; approval of more subprime loans; and in the worst cases, use of fraudulent data to approve borrowers.

Despite many predictions of a correction, housing continued to post record sales numbers for years. However, in late 2006 and early 2007, housing began showing signs of weakness. Then, on March 14th, General Motors posted fourth quarter earnings that took many investors by surprise. Despite its best profits in four years, the company reported a \$651 million shortfall in its subprime mortgage unit. The perfect storm was unleashed as investors began dissecting their mortgage-backed investments only to find subprime loans buried in even the highest-rated securities. Panic ensued, and investors began dumping mortgage-backed investments in favor of higher quality fixed income securities.

Casualties have mounted quickly. So far this year more than 150 mortgage brokers have filed for bankruptcy or dramatically restructured. Additionally, dozens of hedge funds have closed shop or taken sharp hits to their portfolios. Investor hysteria has taken a toll on financial companies as well, with the S&P Financial Sector Index dropping nearly 10% this year. Additionally, millions have lost their homes to foreclosure. Washington has taken notice though. Both the Federal Reserve and the Bush Administration have taken actions to relieve short-term stresses on the market. Few however believe a full bailout is likely.

We believe it will take time for the excesses of the subprime bubble to be worked out of the market. However, given our focus on high-quality fixed-income investing, we believe our clients are sheltered from the direct risks of the subprime meltdown ■

Our Mission

Zemenick & Walker is committed to providing superior investment advisory services to high net worth individuals, trusts, not-for-profit organizations, and retirement plans. As a fee-only, non-discretionary advisor, Zemenick & Walker eliminates potential conflicts of interest and offers clients a disciplined, business-like approach to the investment of their capital ■

Celebrating 20 Years in Business

It was an inauspicious start. Richard Zemenick and James Walker proudly launched their investment advisory firm in October 1987 and within weeks Black Monday left the market staggering from a 22.6% one-day loss for the Dow Jones Industrial Average. However, despite the unlucky timing of its inception, the firm has prospered and has now been helping clients steadily navigate both calm and treacherous markets for twenty years.

Rich and Jim's philosophy was that investors should treat the investment of their capital as if it represented a small business. To assist in this they set out to provide professional, conflict-free investment advice, acting as the Chief Investment Officers for each of their clients. They realized that to eliminate many of the conflicts of interest that are so ingrained in the financial services industry they would have to avoid selling products and instead work on a fee-only basis. In the late 1980s this was a revolutionary business model.

Over time the firm has grown gradually as it selectively added both new clients and investment professionals. What was once a two person office with a handful of clients is now an eleven person investment team with approximately \$1.2 billion in assets under management. The model and philosophy that were established in 1987 continue to guide the firm today ■

Focus on the Economy

These are tumultuous times for the U.S economy. There is no end in sight for a housing market slump that has already sent shockwaves through global credit markets and contributed to an atmosphere of uncertainty and fear in financial markets that Treasury Secretary Henry Paulson and former Federal Reserve Chairman Alan Greenspan agree resembles that which existed in 1987 and 1998.

Recent economic data releases have been increasingly troublesome. Housing starts and new construction permits continue to fall and home prices dropped 3.9% for the twelve months ending in July, according to the S&P/Case-Shiller home price index, which measures home prices in twenty U.S. metropolitan areas. A release for August by the Commerce Department indicated that the median sales price for new homes had fallen 7.5% from a year ago to \$225,700. In addition, the U.S. economy saw a net loss of 4,000 jobs in August – the first time in four years that there has been a monthly loss. Moreover, the previous month's reported gain of 92,000 jobs was revised downward to 68,000.

The debate amongst Fed-watchers is whether the cuts will continue.

In fact, some even argue that to avert a spike in inflation, the cut will have to be reversed, perhaps as early as next spring.

It was against this backdrop that Chairman Ben Bernanke and the Federal Reserve Open Market Committee decided on September 18th to cut the federal funds rate target by ½ percentage point to 4.75% - surprising many economists who expected only a ¼ point cut. In doing so, the FOMC acted to “forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time.” The response from financial markets was emphatic - the Dow Jones Industrial Average rose 336 points on the announcement!

In the aftermath of the rate cut, many are wondering if in its urgency to prop up economic growth the Fed may be taking too large of a risk of stoking inflationary pressures. As recently as August 7th the FOMC noted that, “Although the downside risks to growth have increased somewhat, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected.” In its most recent statement the language changed to, “the Committee judges that some inflation risks remain, and it will continue to monitor inflation developments carefully.” To some this gives the impression that it lowered rates sooner than it had originally intended, though as the *Wall Street Journal* commented, evidently Bernanke “preferred to risk doing too much rather than too little”.

The debate amongst Fed-watchers now is whether the cuts will continue. In fact, some even argue that to avert a spike in inflation, the cut will have to be reversed, perhaps as early as next spring. In the mean time people will be watching the Fed closely for clues about its next move, which for better or worse will have a profound impact on both the U.S. economy and its financial markets ■

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