



Quarterly Memo

July 2007

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Are We Heading for Another 2000-2002?

With stock indices down 6-8% from all-time highs, many Americans are enjoying the great summer past-time: prognostication. I had a conversation with another advisor recently who was struck with this market's similarities to 1907, given the direction of interest rates, gold prices, and inflation. Plus the fact that this year ends in "7". Based on these patterns, the rest of 2007 will be tough, according to him.

So far, he's absolutely right, of course. But in 1907, the Czar ruled Russia, the Emperor ruled China, India belonged to Great Britain, the Federal Reserve didn't exist, and neither did the income tax. Extracting economic patterns from a century ago to make short-term predictions about the present seems a stretch to me.

Of course, it's been said that the four most

dangerous words in investing are "It's different this time!" And we have

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Debt – Americans need more of it!

So says Ken Fisher, *Forbes* columnist and purveyor of investment services to the masses through countless direct mail pieces. Writing in the May issue of *Financial Planning* magazine, Fisher makes a number of dubious assertions that fly in the face of conventional wisdom, if not common sense.

Fisher first asks why we should get upset over consumer or government debt when corporations incur debt all the time? Debt is good, in Fisher's

view, because whether the money was borrowed for a worthwhile investment or a foolish government project, it injects new liquidity in the economy as the money is spent numerous times (the velocity of money). There is no doubt that credit availability can be a powerful monetary stimulus, hence the Federal Reserve's manipulation of interest rates. However, corporations tend to borrow for sound reasons, when the incremental return on an investment

will exceed its cost of capital. The corporation expects to be better off financially as a result of its borrowing. Applying this rationale to someone buying a plasma TV on a credit card is a long stretch.

Fisher then goes on to say that what we need is more debt in order to achieve prosperity – by a factor of 3! "Imagine what we could invest in!" Only "xenophobes" worry about owing trillions of dollars to foreign powers.

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Are We Heading for Another 2000-2002? (continued from page 1)



"In the short run, the market is a voting machine but in the long run it is a weighing machine."

***Benjamin Graham
(1894-1976)***

the poet Santayana's famous observation that "Those who cannot remember the past are condemned to repeat it."

So where lies the balance in learning valid lessons from the past while recognizing that the future may not conform to any pattern of the past? What if it's not just different this time, but it's different every time? To have a hope of making sense of the present, you have to have a framework of absolutes – principles or ideas demonstrated by history to be dependable. These principles may be violated, but only temporarily. Mean reversion inevitably occurs when this happens. Some examples might include:

Human nature is what it is and always will be.

Mankind has a pretty lousy track record of self-improvement. It appears that lust, murder, hatred, and the rest of our evil traits are as prevalent now

as in the past. Anything short of Divine intervention isn't going to change human nature. Sorry, New Age friends – more knowledge doesn't seem to have helped. The "rational" individual investor is still elusive.

Markets will be driven by alternating cycles of greed and fear.

Because of this unchanging human nature, perfect, rational markets will rarely, if ever, exist. With the growth of institutional investing, we're probably closer than in the past. But as long as individuals allow any emotion to enter into their investment decision making, we will have to deal with the schizophrenic madness of the crowd. You only have to look back at the frenzy of 1999 or the funk of 2002. It's only a matter of time before we see some excess of emotion driving the market to an irrationally high or low point. If only we knew

which one was next!

The value of a stock will eventually converge with the intrinsic value of its underlying business.

"In the short run, the market is a voting machine but in the long run it is a weighing machine." These are perhaps the most notable words spoken by Benjamin Graham, considered the father of modern value investing. He understood that the value of a stock – or a market – is, on any given day, a beauty contest. Stocks are priced based on ebullient optimism or dark pessimism. But over time, the value of the stock will eventually converge with its true value. What's the true value of a stock? Like any other financial asset, the true value of a business must be the net present value of the cash flows the buyer expects to receive.

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Clients Provide Outstanding Response to Survey

Our sincere thanks go to everyone who completed our 2007 client survey. As always, your thought provoking feedback is extremely important to us. The 58% response rate was exceptional!

How are we doing? You

gave us an overall 4.7 grade (out of 5) for overall satisfaction. Similarly, you gave a score of 4.7 on recommending Matrix to family, friends, and colleagues. We appreciate your confidence in us!

You also gave us

information on how we can improve. A number of investment advisory clients indicated the need for help in other areas of financial planning, particularly with insurance planning. We are working

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Debt – Americans need more of it! (continued from page 1)

Fisher's next point is that Americans could easily carry more debt. The average home has a 42% loan to value ratio, so there's plenty of equity to be extracted. He calculates only a 24% debt to equity ratio for the average household, low by corporation standards.

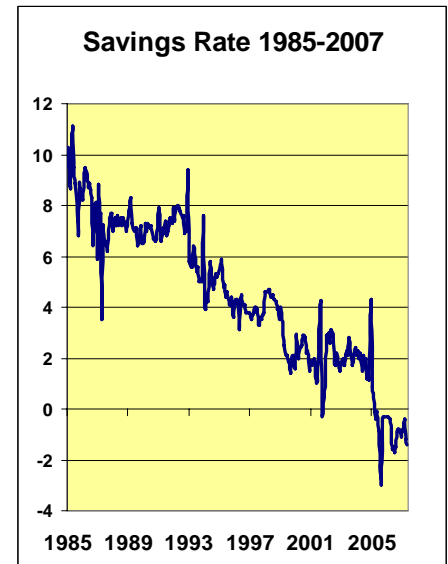
His next target is the often quoted negative household savings rate, which he dismisses as "broken". Granted, the rate produced by the government may have some questionable elements, such as owner's imputed rent and no consideration given to

capital gains or employer pension contributions. Even with its imperfections, the marked deterioration in the rate is alarming. Capital gains and rising real estate values have kept the average household net worth rising and possibly leading individuals to conclude that saving is no longer necessary. Fisher points out that both he and Bill Gates became very wealthy without saving. That may work for a few, but the majority of us will not have such an opportunity and will need to save some current income to fund future consumption. Increasing

asset values can't offset a lack of savings in the long run, though the effects may take a generation to appear. An economic model lacking savings but relying on appreciated asset values to fund growth and investment is unprecedented. It's hard to imagine its sustainability.

Fisher contends that "Americans are the world's best and most consistent savers" but the evidence indicates the opposite. The 2006 Goldman Sachs study *Savings in America: Building Opportunities for All* is a sobering

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Survey Results (continued from page 2)

on ways to expand comprehensive planning services to all clients who desire them.

Matrix has always emphasized a team approach in serving clients. You expressed your confidence in that approach when 70% of respondents said you are comfortable working with a team member other than Giles.

What meeting frequency is most appropriate? A majority of clients believe semi-annual meetings are sufficient.

There was widespread interest in family wealth counseling, trust services, and elder care planning. We are actively exploring ways of providing or coordinating these services.

Once again, Matrix clients proved to be a generous group, with 60% of respondents choosing an appreciation gift of a charitable donation, with 14% choosing chocolates, and 26% choosing a gift card. One client requested the gift card go to a Matrix team member. A nice gesture!

A wide variety of charitable and religious organizations benefited from your generosity, including The Salvation Army, Habitat for Humanity, American Cancer Society, American Heart Association, and the Ronald McDonald House, to name a few.

If you are interested in more details about the 2007 survey, we'll be glad to provide them.

"...you gave a score of 4.7 on recommending Matrix to family, friends, and colleagues. We appreciate your confidence in us!"

“Three millennia ago, a wise observer noted ‘The rich rule over the poor, and the borrower is servant to the lender.’”

Debt – Americans need more of it! (cont. from page 3)

assessment of the status of financial wealth and saving patterns at various economic levels within the US. Broken down this way, the numbers provide insight far beyond that of national averages.

- In 2004, the average net worth of the bottom 50% of households was only \$23,000, with only \$10,000 in financial assets.
- The bottom 25% of households had *negative* net worth and only \$3,000 in financial assets. These families are only one financial crisis from disaster.
- Only 10% of people in the bottom income quintile have a retirement account, with an average balance of \$4,500. 85% of those in

the top income quintile have such an account with an average balance of \$130,000 (still a low number).

- The bottom half of income earners have maintained or increased savings rates in recent years. The top half has seen its savings rate dramatically decline or go negative.

- According to www.creditcards.com, only 40% of Americans paid off credit card balances monthly in 2006.

- The US has the lowest national savings rate among G-20 countries. If Ken Fisher believes that high savings doesn't promote economic growth, witness China's 38.6% savings rate.

In summary, we think

Fisher's views on debt are off-base – voodoo economics at its best. A country or individual cannot borrow its way to riches. We are not 100% anti-debt – there's "good" debt (to buy something that will appreciate) and "bad" debt (for just about everything else).

Three millennia ago, a wise observer noted "The rich rule over the poor, and the borrower is servant to the lender." We believe this still holds true today. Like a knife, debt can be a useful tool or a dangerous instrument resulting in bondage. Be careful with it!

SEC Delays "Accredited Investor" Restrictions

Last year, the Securities and Exchange Commission (SEC) proposed an additional requirement for the definition of an "accredited investor" that could keep many private investment opportunities out of the hands of all but the most affluent. In 1982, the SEC set a standard (Rule 501(a)) designed to protect small investors from private investments that could be risky or complex. The 1982

standard generally required either \$1,000,000 of net worth or \$200,000 of annual income in order to invest in "private placements". The proposal adds a third criterion: an investment portfolio of at least \$2.5 million.

The SEC received over 600 comments, with a large majority opposing the rule. (You can read our response at <http://www.sec.gov/comm>

[ents/s7-25-06/gkalmond4424.htm](http://www.sec.gov/comm/ents/s7-25-06/gkalmond4424.htm))

In July, the SEC decided to put the proposed rule on hold while it studies the issue further. For all the reasons detailed in our response, we were happy to see the proposed rule shelved for now. Occasionally, the government does listen!

Second Quarter Investment Commentary

After an uninspired first quarter, stocks around the world surged in the second quarter before stumbling in July. Domestically, bigger was better, with larger companies delivering the highest returns, followed by mid-caps and then small-caps. It was also a good quarter for growth stocks. Fueled by the second quarter's returns, growth indexes have now out-returned value indexes for the year to date in all market-cap segments. International stocks had another strong quarter and out-returned the U.S. market again.

Non-equity asset classes were mixed. The U.S. bond market was slightly negative for the quarter and only slightly positive for the year. Commodity futures (as measured by the DJ AIG Commodities Index) were negative for the quarter though still positive for the year. REITs suffered a sharp correction, losing 9% during the quarter and have now experienced a 26% decline to date since peaking in early February.

In every economic cycle there are points where the indicators are particularly confusing. During these times investors who try to read the economic tea leaves can be easily whipsawed. So far, 2007 seems like one of those times as investors vacillated between fears

of economic weakness (driven by the housing market and sub-prime lending woes) and strength (driven by the buyout boom and a strong global economy).

At an absolute level, there are no asset classes priced at levels that appear cheap. On a relative level, only large cap domestic stocks appear interesting.

From November 1999 through June of this year, large-caps (S&P 500) had a total cumulative return of only 25% (2.95% annualized) compared to 114% (10.4% annualized) for small-cap stocks (Russell 2000 Index). This sizable performance discrepancy leaves large-cap stocks bargain-priced compared to stocks of smaller companies. Moreover, stocks of larger companies tend to do better when the dollar is weak (their foreign earnings are worth more converted back to dollars and U.S. exports become more competitive), which is partly why mega-cap stocks are now experiencing stronger earnings growth than smaller companies. They also tend to perform much better than small-caps late in the economic cycle. We may or may not be late in this cycle but we are clearly past the early stage.

A reasonable question to

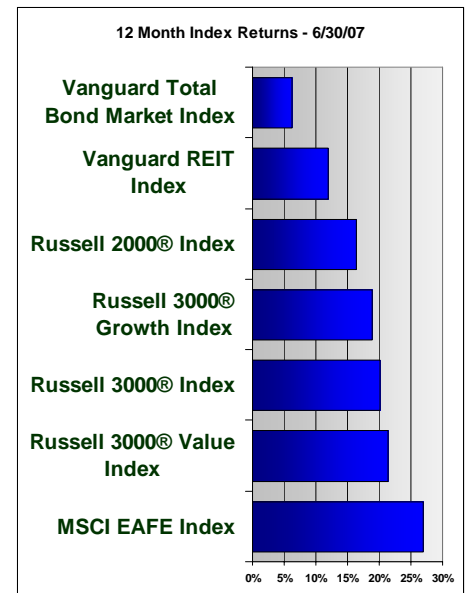
ask is whether large-cap stocks are cheap on an absolute basis, or only a less-pricey segment of an overall market that is expensive. Whether the overall market is expensive is a good question, especially after its very strong second quarter. The short answer is that we believe domestic large-caps are reasonably valued and therefore attractive, though not so attractive that we would pound the table over them.

There is risk to this view. We've just experienced the greatest earnings boom since World War II, thanks partly to profit margins hitting a 40-year high. So the question is: While the stock market looks reasonably valued or even undervalued based on earnings, if profit margins were to move back to "normal" levels wouldn't the overall stock market then be overvalued? There are really two questions here:

- 1) Are profit margins likely to decline significantly?
- 2) If they do, will stocks be overvalued without a price decline?

It does appear that profit margins are likely to decline in coming years:

- Labor costs are a big part of the equation. They have been the biggest driver of declining



“In every economic cycle there are points where the indicators are particularly confusing.”

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Are We Heading for Another 2000-2002? [cont. from page 3]

A stock cannot stay permanently high based on unfulfilled expectations – it will eventually fall if it can't deliver the expected earnings. Likewise, a stock that is beaten down because of low expectations, but delivers earnings will eventually be bid up to its fair value.

So looking at current conditions through the lens of these principles, what observations can be made?

The past few days seem to have been a transition of a fearless mindset to a fearful mindset and an exhibition of the herd nature of the markets. That is certainly an oft-repeated replay from the past. Much like a scene from an old cowboy movie, something spooks a cow in the herd, who begins mooing and alarms others around it. One cow bolts, then another, and the whole herd is off stampeding mindlessly in any given direction. Is that a mooing sound we've been hearing lately?

So the mood meter may have swung back to fearful. Is this cause for alarm? We are not overly concerned for several reasons. First, the meter has not been in the full greed position for some time. It's true that there was a pronounced lack of fear

through the first half of 2007. This was evidenced by the lack of volatility in the markets (see last quarter's newsletter for a discussion) and very low spreads between the yield on Treasury bonds and junk bonds. So far, the recent pullback seems entirely normal and a 10% or even 20% correction can't be ruled out.

When market averages were at their peak, we did get a few calls asking about our feelings concerning the altitude of the indexes. Did this feel like 2000 all over again? Are we being set up for another torturous three years?

While never ruling out such a possibility from heretofore unforeseen events, it is safe to say that there are significant differences between where we are now and the spring of 2000. First, the overall valuation of

the market hasn't been stretched to the incredible levels seen in 2000. Then, the S&P 500 index price to earnings (P/E) ratio peaked at close to 50. This means that investors were willing to fork over \$50 to get \$1 of annual earnings. The fact that people were willing to do so was a sign that a bubble or market mania was in progress. Today, the S&P 500 sells for around 17 times historical earnings or 15 times projected earnings. That's well within what's considered a normal historical range, especially given the interest rate environment. While few would argue that stocks are at bargain levels (a la 1980), they are clearly nowhere near the stratospheric valuations of the late 1990's.

Another take on this is that the markets have indeed risen but for all the right reasons.

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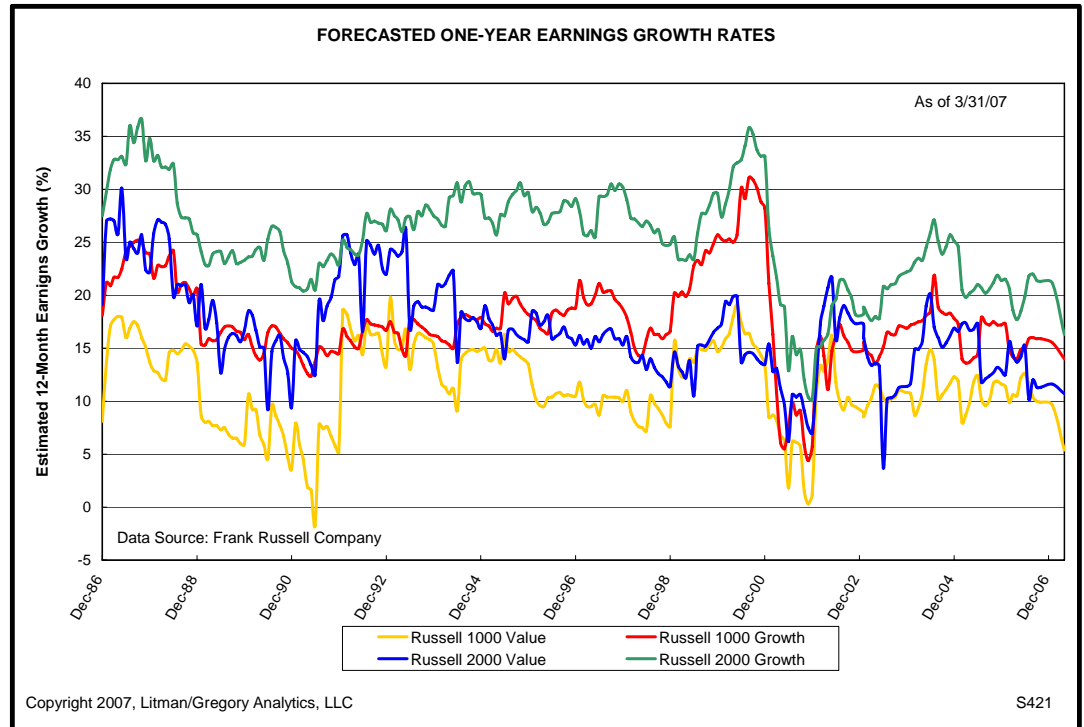
Valuations Are Still Reasonable



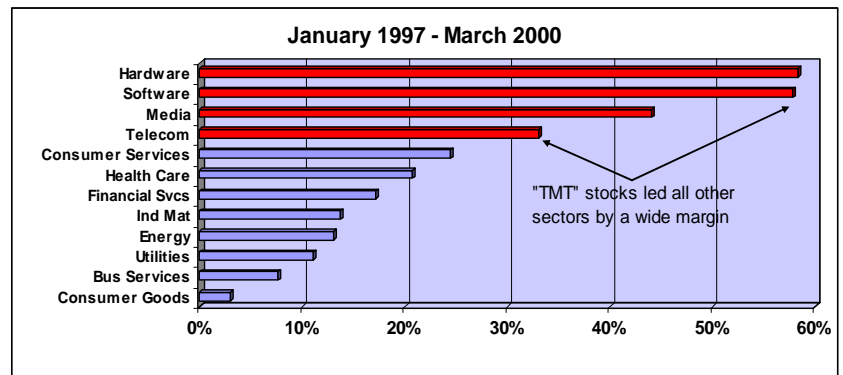
As of June 30, 2007.¹ Source: FactSet, Standard & Poor's.

Why should equities go up in value? If companies are increasing their earnings, then it's an expected response for their price to increase, all other things being equal. That's exactly what has happened in the past four years. Earnings have increased and prices have as well to keep the S&P 500 P/E ratio in the mid to upper teens. Given that interest rates are relatively low, the current P/E ratio looks reasonable – not cheap, but reasonable. For S&P 500 companies reporting so far for the second quarter, the overall earnings growth rate has been a healthy 5.2%. Even if earnings growth slows as expected, it appears forecasted earnings growth rates are moderate (see chart). Contrast this with the late 90's forecasted rates of 30%+.

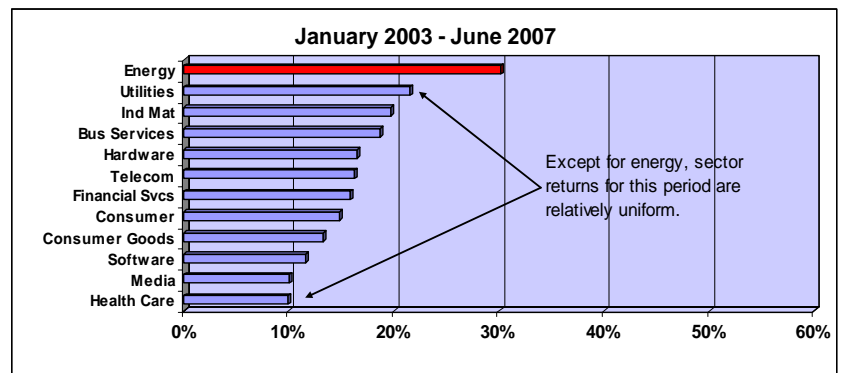
Another significant difference between now and 1999 is the breadth of the market's advance. From January 1997 to the market peak in March 2000, large, mid, and small cap growth stocks had all achieved annual returns of 30% or more. Value stocks, on the other hand, plodded along with returns of 10%-14%. More specifically, the markets were driven by strong returns in what was referred to as the "TMT" sectors – telecomm, media, and technology,



while the rest of the market sectors markedly lagged. This huge performance differential led to technology growing to constitute over one-third of the index by 2000., compared to today's 15% weight.



Fast forward to the period 2003 to the present. We have seen a markedly more balanced advance by the US equities market in this period. Returns for almost all sectors were within a 10% spread, versus a 50%+ range for the late 90's.



So while we can't predict if the rest of 2007 will be like 1907 or 1997, we can say that the world is a different place with different economic and

market forces at work. So whatever the outcome, the causes are different. In that sense, it's truly different this time.

Second Quarter Investment Commentary (continued from page 5)

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margins. The massive growth in the global labor market from China, Eastern Europe, and other parts of the developing world, along with technology-based productivity increases have made it difficult for labor to grab as big a piece of the economic pie. However, labor's lack of leverage may stop deteriorating and gradually reverse, increasing labor costs and putting some pressure on margins. But a big jump in labor costs doesn't seem likely in the foreseeable future.

- Depreciation expense, also a big factor, will also increase given the pick-up in capital in-

vestment the last few years.

- Interest expense is beginning to increase because of new borrowing and rising rates.

So, some margin pressure seems likely as the drivers of widening margins lose their momentum.

However, it is not clear that margins will suffer a huge decline. Top-line growth has been healthy, and given a very strong global economy, revenue growth could stay reasonably strong. And though productivity is slowing and labor costs may not be as much of a positive, there is still an abundant supply of labor around the world and will

be for years to come. China still has a long way to go in its transformation from an agrarian to an industrial economy. So, while we expect profit margins to decline and earnings growth to slow, we are not assuming that the slowdown will be alarming unless there is a recession.

The recent decline is not surprising given the performance run since February 2003. We think the downturn is likely to be a short-lived correction rather than the start of a bear market, unless we are heading into a recession, which is possible but seems unlikely given current global economic strength.

About Matrix Wealth Advisors, Inc.

Planning is in the process of allocating limited resources among unlimited alternatives according to a system of values to achieve life goals.

Founded in 1990, Matrix uses a very personalized, principle-centered process to offer comprehensive financial planning and investment management services that help clients

take action and grow, closing the gap between where they are now and where they want to be. Matrix is a fee-only, fiduciary firm, compensated solely by our clients.



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