# THE LANCZ LETTER

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**Volume 28, No. 12** **October 7, 2008**

## A Bottoming Process But Still Too Much Risk Out There

The extreme downside volatility has brought valuations to more attractive levels, but during times like these the pendulum usually swings to extremes. Global equity valuations definitely look more appealing than a year ago when we suggested raising cash positions. However, **investors are just beginning to understand the complexity in the massive leveraged excesses over the majority of this decade. The ripple effects of subprime are even far greater on a worldwide scale than we feared early last summer**. Hopefully, all subscribers and members have utilized our research and insights over the past 1½ years to reduce risk within your personal, trusts and retirement portfolios. You will hear more and more talk about raising cash in the weeks to come, but the time to do it was one year ago when the S & P 500 hit a record high, or earlier in the summer of 2007 when there were plenty of warning signs that financial markets were heading out of control. The reactive methods utilized to fix the credit problems will not only take much longer to take hold (because of the procrastination), but may in turn establish a new set of problems of which we are unaware. We are still seeing too many investors taking excess risk in emerging and international markets, and would recommend a significant under-exposure in the area, as many of their problems will take even longer than America's to remedy. For the first time in 16 months we are seeing some worthwhile upside in select equities, but that potential upside will take some time before investors will realize meaningful and sustained benefit.

For a list of select equity areas that we would begin to focus on during these volatile times, please refer to our Current Top Buys on page 7. Due to increased demand, we are offering a full credit on your **The Lancz Letter** subscription for investors wanting to upgrade to our daily insights on **LanczGlobal's Member's Only.** Here is just a sampling of the type of information you would receive on a daily basis to help navigate these volatile markets.

### Still Cautious After the Rescue Package – October 3, 2008

Many long term subscribers and clients have been surprised that we have not changed our cautious outlook after a 20-30% drop in equity valuations. After all, we suggested some strategic profit taking back in June 2007 when the market was hitting record highs nearly every day and were waiting for a major sell-off. **So why are we still somewhat cautious?**

Back in 1987 when our Blue Chip portfolio had a 70% recommended cash position at the time of Black Monday's 23% one day plunge, we utilized that sell-off to buy into the panic selling. At the time, the sell-off was a case of portfolio insurance not providing the risk management solution institutions expected, and that created a wonderful buying opportunity. Today's problems are more systemic, and while we feel that eventually this bear market will result in a great buying opportunity, we are simply just not there yet.

For new accounts that were transferred last week, we still sold most of their higher risk equities to dramatically lower their risk. This was obviously a much more difficult decision for us to make than it was one year ago when the S & P 500 was establishing new record highs, but even with passage of the bail-out (or rescue) package, there were still too many factors that concerned us. We mentioned in the last issue of **The Lancz Letter** that since

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Lehman Brothers and Washington Mutual were already on every investor's radar, potential new problem areas that would likely rear their ugly heads would include dramatically slowing economies in the emerging markets and recessions in much of Europe. Earlier this year, we stated several times that European banks will be yet another shoe to drop with many of their financial institutions in worse shape than the U.S. European banks average nearly $1.40 loaned for every $1.00 worth of deposits compared with the United States banks loaning approximately $0.96 of every $1.00.

Another area that we mentioned last month that is still keeping us out of the equity waters is concern regarding further fall-out from the fourth quarter (year end) audits. In our opinion, this is why General Electric recently raised capital in a very dilutive fashion. General Electric chose to be prepared for any potential audit concerns, or worsening of the financial markets, even on unfavorable terms rather than get caught up in a further downward spiral. If a triple A rated company like General Electric could only negotiate such dilutive terms, this demonstrates both how desperate General Electric's board was to raise the necessary capital and how negative the overall environment is on a global scale. Either way investors look at it, the global market still contains significant risk.

**Here is what we felt the equity market had in store for investors as we started the new year:**

> *"LanczGlobal continues to expect a challenging and difficult environment for most equities. When LanczGlobal warned about the markets as they were hitting new highs early last summer, it was before the subprime mess was recognized by Wall Street. LanczGlobal's Strategic Profit Taking call was based on valuations because of the dramatic outperformance in real estate, utilities, and even the financials which had multi-year outperformance that pushed it to 24% of the S&P 500. Once the credit crisis became apparent, LanczGlobal felt (and still does) that the U.S. stock market would not be able to establish significant new highs with all the uncertainty and lack of transparency out there. By mid-summer, ABL warned of pronounced "ripple effects" from the credit crisis that would begin to be seen late in the third and fourth quarter. This was at the same time that many others were still talking about P/E multiple expansion for U.S. stocks and indeed the D.J.I.A. and S&P 500 hit new (albeit modest) highs in July and October. The past few weeks, with Friday's unemployment report along with the latest economic numbers, are finally showing the ripple effects into other sectors (retail, consumer discretionary) from the credit crisis. LanczGlobal feels this will not go away anytime soon, but as stock prices fall here attractive long term bargains are being found that should be bought particularly on weakness. LanczGlobal is telling members to get into the financials sometime in 2008 into this weakness, but that they probably will continue lower after initiating positions. That is why LanczGlobal recommends buying 1/3-1/2 of a typical position only to buy more should further "shoes drop" after the first half write downs regarding some of their troubled assets".*
>
> ***LanczGlobal's daily insights – Member's Only - December 31, 2007***

We felt that the damage of these excesses would have been completed by the beginning of the fourth quarter, making it an excellent buying (or entry) point. However, the delays and slow reaction regarding the credit crisis have prolonged and intensified the global problem. In fact, we have a near perfect storm of events that have exasperated the credit crisis - from the political delays in doing something about it to the liquidations and force selling by hedge funds. Add to that the dramatic slowdown and lost global growth catalyst from the BRIC countries, the crisis of confidence in both the global financial market as well as regarding the consumer, who has been so instrumental in supporting the economy, and investors begin to understand the extent of our problems. We said this 16 months ago and even though some of the risk has been taken out of the global equity markets, it still holds true today: we do not see significant upside in equities with the growing uncertainty in both the U.S. and abroad, and thus would defer exposure in most equities for quality fixed income or even cash for the time being.

We still feel that with the postponement in the $700B package and the delay in seeing any effects in the $700B until next month at the earliest, the confidence needed to re-establish our credit and financial system will take time, and we would rather buy at lower levels into even further panic sellers. From the new accounts coming in and in our talks with other investors across the globe, we still are seeing far too much risk being taken by the average as well as institutional investor, and thus more selling is needed to wash out all the excesses of the past.

# Wall Street Turmoil – Are Your Investments Safe?

Over the past eight years, investors have experienced at least three major bubbles, which are now culminating into one of the most challenging credit crises in many decades. Legendary investor Sir John Templeton warned us 15 years ago that investors would live through an "information overload" period in which volatility and extreme global swings would be much more commonplace and regular investment cycles would fade into a distant memory. The volatility of the past eight years has once again proved the late great Sir John to have been right on target. In true fashion to his proactive style, many experts warned about the overvalued financial and real estate sectors up to 1 1/2 years ago. For those investors who underestimated the effects of subprime loans last summer, there were many other warning signs that should have not been ignored. On July 31, 2007, two Bear Stearns funds that invested in mortgage securities filed for bankruptcy. One week later, French bank BNP Paribas froze three funds with U.S. mortgage exposure as a presage to what was to come for investors worldwide. Even if you did not understand the ripple effects of how subprime loans would create a delirious influence on the entire U.S. financial system, there was plenty of time with these subsequent events to be proactive and lessen one's exposure in these high risk/low return areas.

It was the massive leverage and layered complexity of these complicated securities, such as the credit default swaps, collateralized mortgage obligations and counter party derivatives that so intertwined our financial firms and markets. The fees and commissions on these financial instruments were enormous and the more the transparency dissipated, the more popular (easier to sell) they became. The instruments may change, but it seems the world of finance can never escape the strong influence of both fear and greed. In fact, with the credit crisis well over a year old, we are still seeing investors taking far too much risk in emerging markets and other investments that many times are not suitable for their situation.

For the past decade investors have just jumped from one investment category to another, chasing performance without taking into consideration any measure of risk. For ten years now, passive investors are showing a lost decade of no gains whatsoever in the S&P 500. Investors who chased performance have suffered startling negative returns, but investors who have utilized these extremes to their advantage by strategically taking profits, avoiding the tech/internet craze in 2000, the housing and real estate bubble and the more recent emerging markets and commodity bubbles have done well with a far lesser degree of risk. Which brings us to what may turn out to be one of the most expensive sources of the problem, and that is the lack of direction by many advisors. Here are some of the biggest mistakes and most costly errors we have seen with the recent market turmoil as well as over the past three decades:

1. **Complacency** - We've lost count of how many times new clients have told us their advisor did nothing during events like what we have experienced since last summer. If statements like "be patient, the market will come back" or "you are diversified, don't worry" ring familiar, it has most likely proved costly to your portfolio.

2. **Costs** - we are still seeing large accounts - many of which are taxable - that are in mutual funds or separately managed accounts (SMAs) with high costs. In many cases, the unsuspecting investor is not even aware of the total cost of their investment program. Investors must factor in annual expense ratios, commission costs, and any front end loads & 12b-1 fees just to get an idea of the costs behind their investments. Keep in mind that according to Lipper, your after-tax return was reduced by anywhere from 17-44% over the past decade due to taxes alone.

3. **Risk** - everyone likes to talk performance but a key to long term success is to ascertain, and limit, risk prior to making every investment. This includes a daily assessment of risk, not periodic rebalancing or over-diversifying into all asset classes, which may sound good, but falls short in volatile global markets. Arbitrary rebalancing is a reactive, novice measure to reduce risk in these volatile markets and investors hoping to limit risk by investing in a broad range of asset classes have learned this past year how interrelated such asset classes can become. We have never understood why an investor would want to hold financial stocks from their all time highs during the summer of 2007 or technology stocks at ridiculous valuations during the start of this decade.

The U.S. financial picture is filled with such a multitude of asset gatherers that sound like they know what they are doing, but who are putting many Americans in precarious financial situations. Perhaps they even believe that rebalancing twice a year or diversification into many asset classes will be enough to protect investors. These are times to be more concerned with the return of your investment dollar rather than the return on your dollar. Since many advisors sound so authoritative and knowledgeable to the average investor, we feel the old questions of "how are you compensated", "are you registered with the Securities & Exchange Commission", and "what are you doing to protect investor's assets" are not enough and specific follow-up questions are needed to verify that the advisor's actions match the talk:

- Do you sell a product?
- Have you ever recommended to a client or sold any of the following: Auction-Rate Securities, Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac or AIG products?
- How much exposure in financials did your clients have during the summer of 2007?
- What, if anything, was done to lessen this exposure and when?
- How much international and emerging market exposure did you have going into calendar year 2008?
- If you were in business in 2000, what was your technology exposure for clients at that time?
- Do you ever raise cash (take profits) in good times to have the ability to selectively buy when valuations go down?
- How much cash did your accounts have one year ago, for example, when the credit crisis was already on investor's radar or in prior extreme times like 1987?

These questions are just a start to see if your advisor shows an actual record of being proactive, or is just talking a good game. During times like these we would rather steer towards advisors who have protected capital in the past, rather than ones learning on the job. The upcoming $700B rescue plan in the U.S. is the first step in correcting all the excesses of the past 7-8 years. It is a move that is much more dramatic than what it would have been if the heads of our financial companies would have acted right away instead of ignoring the problem. This will protract any recovery and make the entire process much more costly - both in terms of future taxes and inflation - for many years to come. After being negative on financials since early summer 2007, we are finally seeing a light at the end of the tunnel with the passage of a major bail-out plan. Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac, AIG and Wachovia were all band-aids that failed to address the systemic problem. Now a course for the cure is finally being coordinated, but after such delays and mismanagement, the journey will be much more difficult and challenging for everyone.

**Two Things Investors Should Learn From the Current Financial Turmoil:**

1. Spreading risk does not eliminate, or even limit, risk during volatile markets. This is true at all levels from asset allocation strategies to complex derivative securities. If it is a risky asset to begin with, it will be risky in combination with other assets, no matter what Wall Street tells you.

2. During volatile times it is critical to be proactive, rather than reactive. It is definitely easier to do the latter and follow the herd, but investors must learn to continually monitor and reduce risk on an ongoing basis - not just periodically.

### Market Notes

**UPDATE: Tuesday, 7:55 AM, September 30, 2008** - After 16 months of warning investors about the excesses in real estate and the financials (see Strategic Profit Taking 5/30/07), we thought that this bail-out package would be the first small ray of light at the end of the tunnel. Thinking it was going to pass yesterday (see Forbes 9/29/08: Thoughts on the Bail-Out), we let investors know that this will be just the start to the bottoming process in establishing a floor and restoring much needed confidence. Last week (see below), we suggested investors utilize the 900 point turnaround in the D.J.I.A. upon the initial talks of the bail-out plan as an opportune time to lessen one's risk (if they had yet to do so over the past 16 months) in their investment portfolio and lock-in at least partial gains in many of our outperformers. It was difficult last week to raise cash for the new accounts coming in that were fully invested. After all, it is more of our style to have raised cash last summer, but in assessing the risk of these new accounts, they were coming in with much more risk than what the client wanted or understood. Yesterday was the first day we did not raise cash for the new accounts that came in early that morning or over the weekend. It is never smart to follow the herd during market extremes, but rest assured - if these new accounts contain too much risk now, changes will be made into any rally attempts to lessen risk and better position these investment portfolios. If you are always fully invested, you will never have the cash available to selectively take advantage of major "panic" sell-offs. The credit markets are still clogged up with Libor at an all time high, so even that small ray of light has dissipated for now.

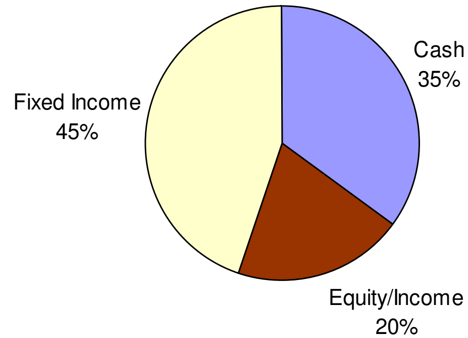
**Monday, 3:05 PM, September 22, 2008** - Many investors are comparing the recent credit crisis to 1929. We feel that we have further to go in the process but the government's $700B bail-out plan is the first step to actually remedy the problem. Even though we recommended a large cash position before the "Crash of 1987" we did not have a chance to take profits into the sudden plunge like we do today. We listed a number of our favorites in The Lancz Letter that were (and still are) hitting new highs in the face of this onslaught of sellers. In 1987, we did not have this luxury and could only utilize the cash we raised that summer while the markets were still in rally mode. The 900 point turnaround late last week gave investors further opportunity to realize gains or lighten positions in high risk areas into significant strength. We locked-in gains in our select financials like Cullen/Frost Bankers which hit an all time high on Friday as well as partial profit taking in old favorites like Nicor, CH Energy, Fresenius Medical and Fastenal Company. Such a nimble and disciplined approach is crucial in these types of volatile/uncertain times and investors should remain very selective.

# ABL 401K TACTICAL ASSET ALLOCATION RECOMMENDATION

# OCTOBER 2008

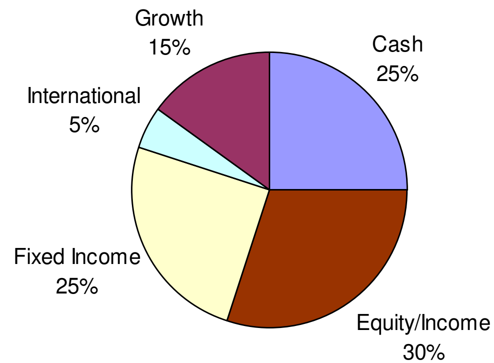
### CONSERVATIVE

AVOID: Emerging markets
LIMIT: International, energy & commodities
FOCUS ON: High quality fixed income & equities



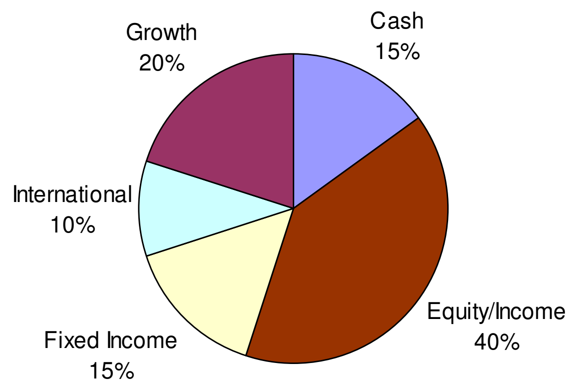

### MODERATE

AVOID: Emerging markets
LIMIT: Commodity/energy exposure
FOCUS ON: High quality, strong balance sheets, companies with lots of cash and little debt




### AGGRESSIVE

AVOID: Emerging markets
LIMIT: International exposure particularly economically sensitive and financial
FOCUS ON: High quality, strong balance sheets, dividends

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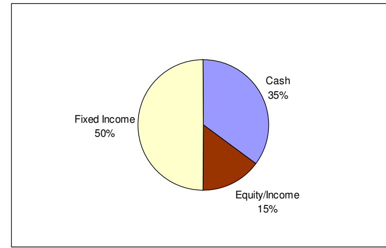
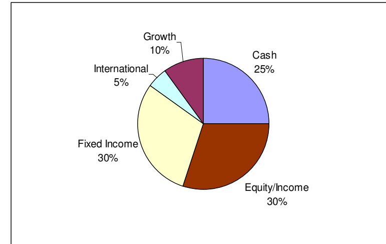
# JULY 2008

## CONSERVATIVE



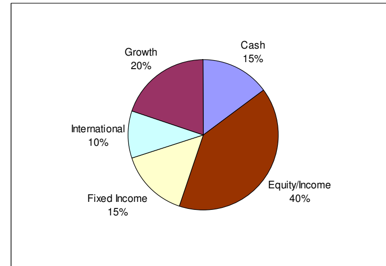

AVOID: Emerging markets
LIMIT: Energy & Commodity exposure
FOCUS ON: Initiate exposure in high quality beaten down financials

## MODERATE




AVOID: Emerging markets
LIMIT: Energy & Commodity exposure
FOCUS ON: High quality dividend paying equities including limited exposure in select financials

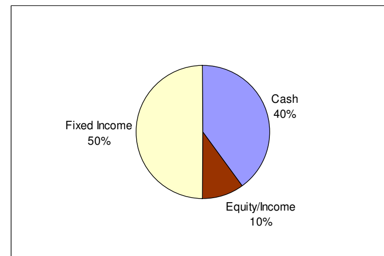
## AGGRESSIVE




AVOID: Emerging markets
FOCUS ON: Global industry leaders with defensive characteristics

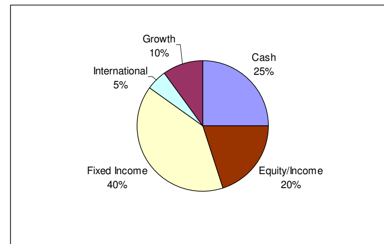
# JANUARY 2008

## CONSERVATIVE



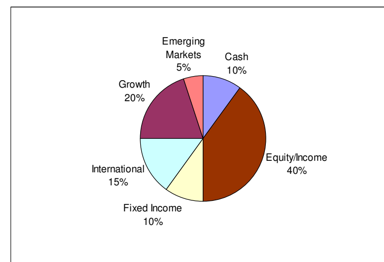

AVOID: Financials, Real Estate, Emerging markets
LIMIT: International & cyclical exposure
FOCUS ON: High quality, conservative areas of fixed income & equity/income

## MODERATE




AVOID: Financials, Real Estate, Emerging markets
FOCUS ON: Defensive equity exposure

## AGGRESSIVE




AVOID: China & India in Emerging markets
FOCUS ON: Global industry leaders with defensive characteristics

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INVESTMENT STRATEGY FOR A CHANGING WORLD

# Are You Taking Too Much Risk?

**If you're concerned about the recent global market volatility, Alan B. Lancz & Associates, Inc. is offering a free, no obligation, independent analysis of your current financial portfolio. Simply fax 419-536-5401 or email abl@ablonline.com a copy of your most recent statement(s) and we will evaluate your holdings based on risk, cost, and performance. Over the past year we have been seeing the average investor taking too much risk of which they were not aware.**

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**(6/1/07) CNBC Appearance - Strategic Profit Taking live at the NYSE**

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# Could Our Independent Research Help You? You Be The Judge.

"There are a record number of bank loans out there and some of the covenants aren't as disciplined as they should be. In 2006, we had a record issuance of high yield debt and 2007 YTD is on pace to break that record. You add in the subprime loan problems and the hedge fund derivative problems… THERE IS GOING TO BE SOME DOWNSIDE!"

Alan B. Lancz – CNBC Bull vs. Bear debate – June 29, 2007

"The Party's Over on Wall Street. All of the things that were propelling us higher kind of evaporated."

Alan B. Lancz - CNN/Money - July 18, 2007

"The financial sector comprises over 20% of the S&P 500 and any further fall-out in the sub-prime arena will definitely have a dramatic and immediate impact in the financials as well as the overall market."

Alan B. Lancz - The Lancz Letter - June 27, 2007

"High flyers in technology do not make sense - we would still avoid them as there is too much risk in the Apples and Research in Motions. We would still avoid financials - sometime in 2008 we will gradually get involved, but there is too much uncertainty for us right now."

Alan B. Lancz - CNBC - January 11, 2008

"G.E.'s results offered new evidence that forecasts for corporate profits in general remained too rosy. They're facing a lot of headwinds that I don't think a lot of analysts have put into their numbers. The Federal Reserve's moves last month to head off the collapse of Bear Stearns might have led some investors to become complacent about the scope of the troubles still facing the economy."

Alan B. Lancz - New York Times - April 11, 2008

"The recent troubles at Merrill Lynch give an idea. At first, the U.S.'s largest brokerage said it expected $5.5 billion in losses in the quarter from losses in mortgage-backed debt and other credit troubles. Less than a month later, that number was up to almost $8 billion. When there's that much change in a few weeks, it just shows the complexity of these instruments, and that they were getting involved in areas they didn't understand."

Alan B. Lancz - BusinessWeek - October 29, 2007

"We went into 2008 avoiding emerging markets - China, Russia, and India - as well as the financials, and would rather concentrate on high quality global leaders with solid dividends."

Alan B. Lancz - CNBC - June 30, 2008

"I think we're going to see another shoe to drop, probably overseas as far as with the financial institutions."

Alan B. Lancz - CNBC - March 23, 2008

"Unfortunately this failure to act will extend and broaden the ripple effects from this credit crisis, which means that investors should continue to maintain a very selective, cautious approach. Rising energy and food costs, the negative wealth effect and plunging consumer confidence all will provide difficult headwinds for equities."

Alan B. Lancz - The Lancz Letter - July 2, 2008

"The glory days of being up every month are going to be over."

Alan B. Lancz - CNBC - July 29, 2007

"It's smart to start taking some profits and not chase stocks indiscriminately here."

Alan B. Lancz - CNBC - June 1, 2007

"You really have to watch out as far as the downside in anything housing because I don't think we are halfway done with the problems with housing yet."

Alan B. Lancz - Bloomberg TV - September 14, 2007

"When Circuit City's stock moved up on Best Buy's surprising earnings last week, it turned out to be an excellent "short" opportunity because it is definitely one of the have-nots."

LanczGlobal's Member's Only Lancz Long/Short Portfolio - October 4, 2007


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