Market Update FAQ

January 22, 2008

Frequently Asked Questions

Why is the market down so much today?

In reaction to Friday's (1/18/08) U.S. market sell-off and investor fears of a U.S. recession that might curtail U.S. demand for imports and slow global growth, on Monday, while U.S. markets were closed, stock markets in Europe and Asia (and elsewhere) took serious hits. The Dow Jones Euro stock index fell 7.3%, the U.K. FTSE fell 5.5%, the France CAC index fell 6.8%, and the German DAX index fell 7.5%. In Asia, Japan's NIKKEI index fell 3.9% and the Hong Kong Hang Seng index fell 5.5%. Many emerging market stock price indices were down by similar amounts.enjoyment, job satisfaction and fulfillment, and community.

Are we in a bear market?

No, but we are close. Most define a bear market as a 20% decline from market peaks, and currently, most major U.S. indices stand just above that level.

Is this a prolonged downturn or a market pullback?

While the market has broken its regular pattern of 5-9% corrections, LPL Financial Research still views this recent market volatility as a market correction and not the start of a prolonged market decline. Specifically, we see this correction, which can be characterized as a sharp, short, severe, decline, as near its end, and we anticipate it to be followed by a "V" shaped recovery.

Are we in or headed toward a recession?

After very careful consideration, the LPL Financial Research Group continues to think that the risk of a U.S. recession at this time is not high, although the prospects have risen slightly. While we do have significant problems in housing and the financial markets' ability to deal with sub-prime mortgage issues, we also have significant positive factors at work.

What are the catalysts to create a positive impact for the market?

There are many positives in the market that are currently being overlooked in the face of investor fear. These positives include:

- Low interest rates and a Federal Reserve that is already in easing mode, with more rate cuts likely in the near future. In fact, the Fed lowered the Fed Funds rate by an additional 75 basis points this morning. (See John Canally's report on this decision.)
- Low U.S. stock market valuations that are in line with the lowest levels in 17 years.
- Strength in the economy in other areas, notably exports.
- Continued very careful cost control by U.S. business: avoiding excessive hiring, excessive wages, excessive inventories and excessive capital investment.
- Housing has already seen the "excesses" removed given it is already two years into its correction.
- Earnings and guidance is likely to be better this week, given that more companies from stronger performing sectors are due to report.
- Company earnings (of non-Financials and Home-builders) continue to be quite strong.
- Virtually all of the bad news is largely priced into the market already. In fact, the bond market is priced for a recession, and many companies are trading at levels below book values. As a result, we anticipate increased share repurchases by corporations.
- Some fiscal policy stimuli have been proposed that may help.

Does the market have continued declines in store?

Given our relatively positive view on the economy and the catalysts that can drive the market higher from these oversold levels, we believe this is just a mid-cycle slowdown with additional declines limited to a 3-5% range.

What about the US dollar? Has it continued to fall?

No. The dollar exchange rate has continued its (small so far) rebound, despite the turmoil. We believe that a stable to rising US dollar exchange rate would make U.S. equity prices attractive to international investors.

Oil prices have declined. Is this a positive?

We are seeing a continued decline in crude oil prices, which may have a very short-term negative impact on equities, but if sustained, will become a major positive for the market.

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What will the Fed do, if anything?

Federal Reserve is already in easing mode and LPL Financial Research anticipates more rate cuts in the near future. In fact, the Fed, in an intermeeting move, lowered the Fed Funds rate by an additional 75 basis points this morning, which resulted in reducing the market's pre-open losses.

Should I move clients to cash?

Given all of the positive catalysts that could stem and reverse the downside move of the market, LPL Financial Research does not recommend selling into these oversold market conditions.

Should I change my client's asset allocation?

A client's asset allocation, which is tied directly to their Investment Objectives, should have a longer-term view. We would never suggest changing a client's investment objective based on short-term fear. Any such change should come from a shift in client goals.

What should I do with new money?

LPL Financial Research does not feel that we can call the exact bottom of the market in these volatile conditions. However, we do feel that the market will close the year significantly higher from current levels. As a result, we would recommend confirming the client's risk tolerance and investment objectives, and then following with a dollar-cost averaging* strategy of new purchases.

REITs have been severely hit. Should I reduce or remove my allocation?

LPL Financial Research does not suggest removing an allocation to REITs at this point, given the 30% declines we've already seen and the value of the sector's 5.2% average yield. We still believe that there could be downward pressure on real estate values that could cause further volatility, but these declines have most likely already been reflected in the traded REIT markets. We continue to suggest holding no more than 3-5% in REITs to diversify equity exposure. For new money, we suggest a global implementation to REITs and dollar-cost averaging.*

How has LPL Financial Research's tactical asset allocation shifts fared year-to-date?

LPL Financial Research's dynamic shifts towards growth and large cap have added value in 2008, as growth is slightly ahead of value and large cap is significantly outperforming small cap.

How have the OMP, SAM and PWP models held up in this market turmoil?

Diversification continues to be a powerful force and is helping limit investors' downside. The Income with Capital Preservation models, for example, are seeing a decline of less than 2% through 1/18/08. The all-equity Aggressive Growth models, however, as might be expected with this type of short, severe change, have declined in the 13% range, in line with or ahead of benchmark returns.

Have active managers held up better in the market's decline?

However, given the market's equal opportunity and broad punishment of both quality and riskier investments, active managers have not seen a dramatic advantage over the short-term. However, as fear and negative sentiment give way to fundamentals, LPL Financial Research looks for active managers to outperform.

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*Such a plan involves continuous investment in securities regardless of fluctuation in price levels of such securities. An investor should consider their ability to continue purchasing through periods of low price levels. Such a plan does not assure a profit and does not protect against loss in declining markets.

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