

Highlights

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- ◆ Brokerage Failures
- ◆ Mortgage Giants Fail
- ◆ Derivative Calamity
- ◆ A Banking Holiday

Worst Case Scenario

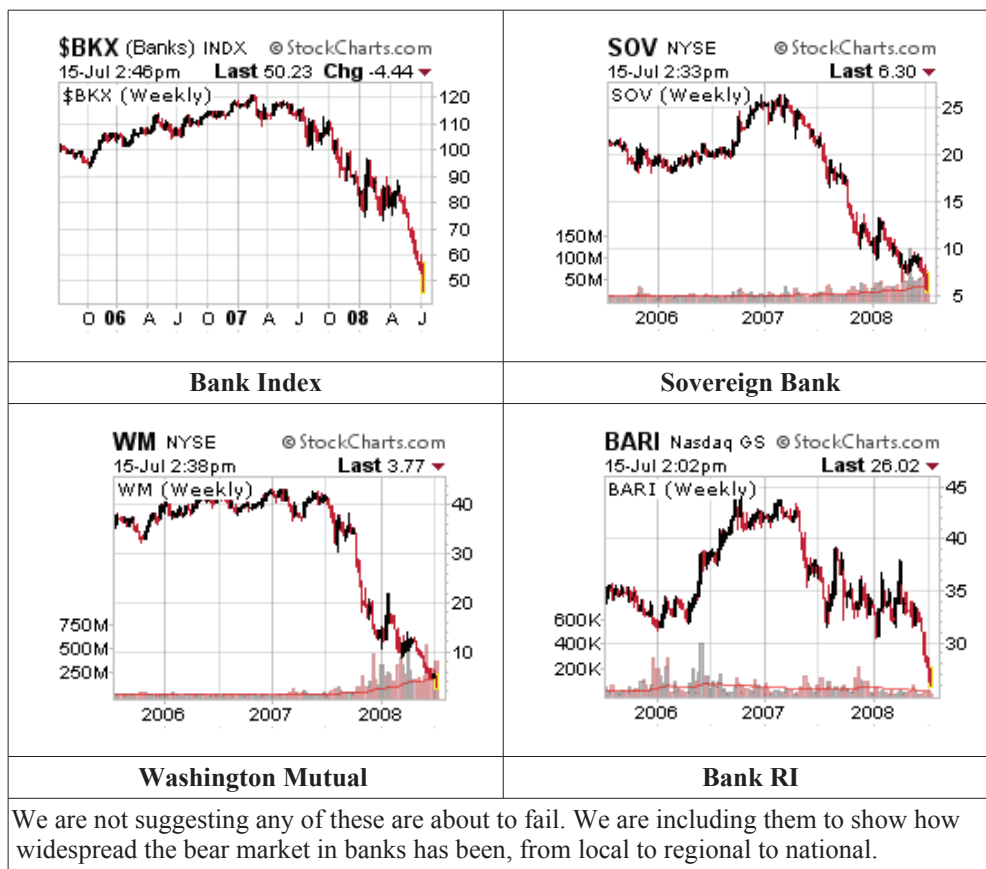
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What a year - bank and brokerage failures, Federal bailouts, sub-prime mortgage mess and a looming derivative disaster. What would happen if things continue to unravel? What would that look like?

Runs on the Banks

With the failure of IndyMac, we've already seen a run on a bank force its closure. What if a few more banks had runs? Depositor panic could cause runs at several banks that are on the edge of failure. A run could push them over.

The FDIC is spending about 10% of its reserves on bailing out IndyMac. How many more depositors can they protect? And they aren't making all of the Indymac depositors whole, about 10,000 depositors had more than 100,000 on deposit. The initial word from the FDIC is that those depositors may only get 50 cents on the dollar for amounts above \$100,000.



We are not suggesting any of these are about to fail. We are including them to show how widespread the bear market in banks has been, from local to regional to national.

Brokerage Failure (maybe more than one)

The failure of Bear Stearns should act as a warning to other brokerages that are heavily invested in sub-prime mortgages and derivatives. The Fed's response was to give brokers access to an emergency fund. Several large firms including Lehman, Merrill and Goldman have had to utilize these funds. Yet their stocks continue to tumble as losses mount. Which will be next?

Fed Chairman Bernanke, for all his "wisdom", has already announced that he expects to see another brokerage fail before the end of the year. Will the Fed set up another emergency fund? Will there be more bail-outs? Did the last one help?



As Seen in

Forbes

Cornerstone Investment Services has been chosen by Goldline Research as one of the **Ten Most Dependable Wealth Managers of the NorthEast**



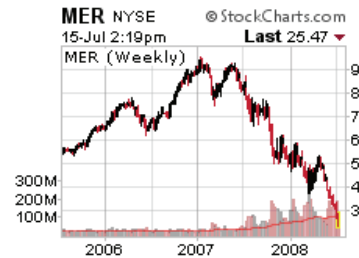
Brokerage Index



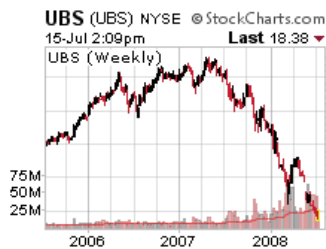
Lehman Brothers



Morgan Stanley



Merrill Lynch



UBS PaineWebber



Legg Mason

Like the banks, brokers have been in a severe bear market of their own making. Sub-prime and derivatives have created a toxic cocktail. With some brokers down over 60% it is anybody's guess where the bottom will be and which ones will survive.

Mortgage Giants Fail

According to Fannie Mae and Freddie Mac's own year end statements for 2007, they have less than 2 cents of assets for every dollar of mortgage and debt liability. Former Fed Governor William Poole has said that the two are already insolvent, based on certain accounting methods.

We've already seen the Fed's "bail-out" of Fannie and Freddie, if you can call it that. It is no more than letting them borrow more money to solve a problem of borrowing too much money.



Fannie Mae



Freddie Mac



CountryWide



National City

Fannie Mae and Freddie Mac were supposed to handle the best quality mortgages. They don't look any better off than the sub-prime lenders like Countrywide and National City.

A Derivative Calamity

We've seen how much the major banks have in these esoteric instruments. ([Trillion Dollar Secret](#)) The failure of Barings Bank and Long Term Capital (LTC) shows the damage they can do when they go bad.

Former Fed Chairman Alan Greenspan testified that the reason the Fed bailed out LTC was to prevent a collapse of the US economic system. LTC's bailout was only a billion dollars. JP Morgan, Citibank and BankAmerica combined have over \$150 trillion in derivatives. Yes, TRILLION.

JP Morgan has assets backing up their derivatives of only 1.56%. By comparison, Citi and BankAmerica are solid as rocks with a whopping 3.57% and 3.43% respectively.

Notional Amount of Derivatives 1st Quarter 2008			
	Total Assets	Total Derivatives	Asset/ Derivative Ratio
JP Morgan	\$ 1.40 trillion	\$ 89.99 trillion	1.56%
BankAmerica	\$ 1.33 trillion	\$ 37.94 trillion	3.57%
Citibank	\$ 1.29 trillion	\$ 37.69 trillion	3.43%
Wachovia	\$.66 trillion	\$ 4.88 trillion	13.64%
HSBC	\$.18 trillion	\$ 4.28 trillion	4.40%

Source: Comptroller of Currency Format: CIS

Increase in Derivative Portfolios past 12 months	
JP Morgan	27.08%
CitiBank	25.35%
BankAmerica	32.95%
With everything that has happened in the past year, these banks continued to pile on these risky investments.	
Source: Comptroller of Currency Format: CIS	

Since derivatives are not regulated, they are not marked to the market daily, so we have no idea how much of a price swing their derivative portfolios have. But given our knowledge of other markets, it is safe to assume value changes of 1% to 2% are normal in any given week.

And since our recent history tells us we should question the assets of banks, can we really be sure of the value of JP Morgan's assets? Or Citibanks? Or BankAmerica? How much of their assets are non-performing? How much are New England mortgages? How much are credit card balances?

If one of the big three fail, what does the Fed do then? They don't have anywhere near enough money to bail them out. And because of the counter-parties involved in derivatives, it is likely that the failure of one party could lead to the failure of several others. This was the concern with Bear Stearns, and why the Fed acted so quickly. But Bear was nowhere near the size of a JP Morgan or Citibank.

Concentration of Derivatives	
Top 5 banks	96.90%
All other banks	3.10%
Source: Comptroller of Currency Format: CIS	

A Banking Holiday

Let's continue down this dark road a bit further and assume the worst has happened and the Fed is forced to contain the economic disaster by declaring a banking holiday. It is not as much fun as it sounds. Banks are closed until they can prove their solvency and with the continued decline in real estate, this gets harder and harder for banks.



Recent history with the S&L crisis of the late 80's and the failure of RISDIC in RI in 1990, shows how our automated lives can work against us. In 1990, payroll check kept getting direct deposited into failed S&Ls in RI. It took weeks to stop the system and employees had no recourse or access to their paychecks. Automatic mortgage payments weren't processed. ATMs didn't work.

If the Fed called a banking holiday, it is very likely they would also

close the stock and bond markets in the US, similar to after 9/11. Maybe they would be closed for a week to help calm things down. But overseas markets would still be open and it is very likely that the Dollar would collapse, commodities and gold would skyrocket and foreign markets would tumble. When the US Markets re-open, it is likely they would also drop (a polite word for crash).

Macro bad – Micro good

While this is a terrible scenario, it doesn't have to be for wise investors. Smart investors can take advantage of much of what is going on through strategic asset allocation and a flexible strategy.

The average Wall Street portfolio will suffer tremendous losses if this scenario plays out, with heavy losses in both the stock and bond markets.

But investors heavy in gold, commodities, (especially oil and agricultural commodities), and market hedges should not only be protected but profit from the worst case scenario. Investors that have hedged the US Dollar should also see profits from a collapse of the Dollar. And even if the foreign markets fall, say 20%, if the Dollar drops 25%, a US investor in foreign markets profits.

Hedges work in the opposite direction of the underlying index or investment. This is a way to profit from the decline of a market.

Investors that can't construct this type of portfolio on their own or have the ability to manage their assets through a crisis like this should look to a professional money manager that has a real strategy for a bear market. Look for someone that has a proven track record of beating the markets over the past several years by avoiding following the Wall Street crowd.

You can see **Cornerstone's Model Portfolio** here: www.cornerstoneri.com

You will see that it has beaten the markets this year and over the past several years with a very low risk (Beta) You will also see that the asset allocation is vastly different than anything Wall Street would utilize and is prepared for what is likely to come in the next several months and years. Our strategy is proactive. It appears to us that most money managers on Wall Street are reactive. They wait until it is too late in many cases. Do we think the Worst Case Scenario will happen? It may not. But recent events tell us it is better to be prepared than surprised. We would rather not wait to see if it happens, would you?

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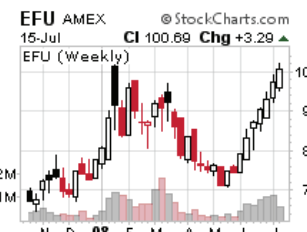
Index Hedges



UltraShort Dow30



US Dollar Index Bearish



UltraShort Financials

UltraShort MSCI EAFE

Hedges work in the opposite direction of the underlying index or investment. This is a way to profit from the decline of a market.