

THE  
PACIFIC  
FINANCIAL  
GROUP  
INC.

# Quarterly

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“When written in Chinese the word “crisis” is composed of two characters – one represents danger and the other represents opportunity.”

- John F. Kennedy



**Megan Meade**  
*President, The Pacific Financial Group, Inc.*

## Letter from the President

Currently I am being asked by our clients “What should I do, considering what is happening in the market?”

I am tempted to say “You have already done it; you have retained us to take care of your assets”. But, I haven’t said that to anyone – yet.

The market we are in is a natural as birth and death. Major bear markets occur from time to time, (usually about every 12 to 15 years) and they are one of the elements of the investing landscape. You can reflect upon the bear markets of the early 70s, mid 1980s and early 2000 to name some of the most recent. You can ask yourself are they tragedies, buying opportunities or just part of the investing world?

Market reversals are tragedies; if you

panicked and sold after the major move down. If you sold at the bottom you locked in a loss. This loss once locked in is difficult to impossible to recover from. The loss of resources in this manner is truly a sad event.

Market reversals are buying opportunities; if you had the courage (and the money) to invest at the bottom you made a great deal of money.

Market reversals are just part of an investment cycle; if you held your position it was just part of the investment world. The market came back, your investments were intact and you were okay.

The attached chart of the S&P 500 illustrates these points.

So, getting back to the question “What should I do?” I think you should buy. If

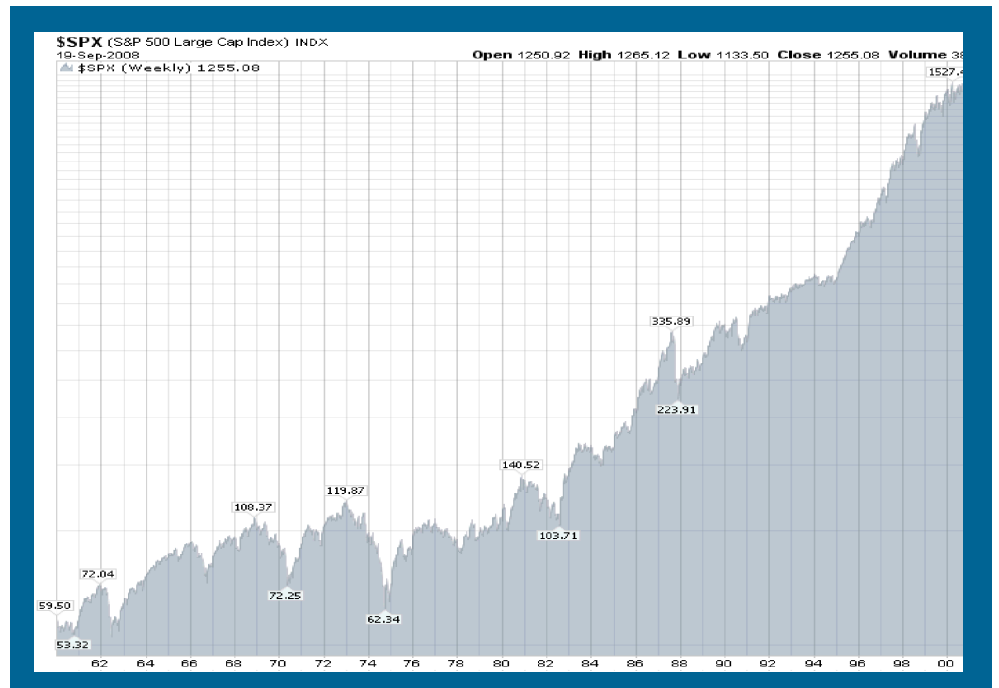
you are unwilling or unable to buy, stay the course.

History tells us that if you are able to buy you will make a lot of money. If you are unable to buy hang on for the ride, and you will be okay. But if you sell, that will be unfortunate because you will lose, and lose big.

We will be managing your money, within the strategy you have chosen. We are acting to protect your assets, and to the extent possible cash in on the upcoming market recovery. We have done it before; we will do it again.

We are here for you, the market will recover and you will prosper.

Warmest regards,  
Megan Meade, President



## HIGHLIGHTS

- Syria established diplomatic relations with Lebanon, ending 6 decades of non-recognition of its neighbor's sovereignty.
- Since 1960, the S&P 500's longest bear market occurred during the 2000-02 tech bust. That bear market lasted 824 days, with a drop of 51%. The recovery from trough to peak took 60 months. The longest recovery period was 69 months after the 1973-74 bear market, when the S&P 500 fell 48.2%.
- President Bush signed into law sweeping improvements in railroad safety that might have prevented the deadly collision of a commuter train and a freight train in Los Angeles last month.
- The number of people with high blood pressure is increasing with obesity rates, according to the National Heart, Lung and Blood Institute. About 29% of Americans suffered from high blood pressure in 2004, up from 24% six years earlier. Only 41% of Americans had normal blood pressure levels.
- Worldwide personal computer shipments rose 15% in the third quarter from a year ago on the strength of low-cost mini-notebooks. HP was #1 worldwide in PC shipments, but Acer took the top spot in Europe, according to Gartner.
- Despite a global slowdown, China, the world's fourth-biggest economy's trade surplus hit \$29.3 bil in September, thanks to a sharp drop in oil and commodity prices. Overall exports rose 21.5% to \$136.4 bil, while imports jumped 21.3% to \$107.1 bil. Exports to the U.S. are still growing, but the pace has slowed.
- The Fed, European Central Bank, and their counterparts in U.K., Canada, Sweden, and Switzerland all cut their key interest rates by 50 basis points in an unprecedented joint action on October 8. China and Hong Kong also cut rates; Australia eased the previous day.
- The gauge of existing-home contracts signed rose 7.4% to 93.4, breaking out of a year long range near lows. Year over year, sales climbed 8.9%, the first gain in years.

# Portfolio Commentary 09-30-08

## Equity Portfolio

The Equity Strategy performed within our expectations during the quarter. We began the quarter with the Portfolio defensively positioned. However, a couple weeks into the quarter, the market began trending upward. We choose not to reposition the Portfolios at the time as we believed the upward trend would be short lived. Our predictions were correct and the market peaked August 28th and what followed were some of the sharpest sell offs the market has seen in decades. Because of our defensive positioning, we were able to protect against much of the September and early October downturn and the Portfolio performed much better than the market during those downturns. Our priority during these turbulent times is to defend against down moves and to preserve capital, so while we are thus defensively positioned we generally don't expect to keep up with the short term up moves. However, as the market turns we will adjust our portfolios to move up with the market.

Exposure to specific sectors was adjusted slightly during the quarter. The Healthcare sector (a traditionally defensive sector) was increased, and our exposure to the Energy sector was reduced as a result of unfavorable performance. Additionally, a sharp downturn in global demand resulted in a significant decrease in our international exposure with most of the proceeds invested in fixed income securities. As of quarter end, international exposure in the Portfolio was approximately 1% of the total Portfolio, while bonds represented approximately 40% of the Portfolio.

## Balanced Portfolio

The Balanced Strategy is designed to offer a blend of fixed income and equity exposure, with emphasis on bonds or equities, depending on current market conditions. As we saw during

second quarter, the third quarter was a clear win for fixed income securities. Bonds, as measured by the Lehman Brothers Intermediate Government Credit Index, were only down -1.19%, while the S&P 500 was down -8.88% for the quarter. Our allocation of approximately 60% fixed income and 40% equities remained the same during the quarter.

Trading during the quarter focused on downside protection. Changes to the Portfolio included an increase in Healthcare (a traditionally defensive sector), and a reduction in energy as oil prices have fallen dramatically since peaking at \$147.27 on July 11th. Investments in the international markets were almost entirely eliminated as the economic downturn began to spread overseas. Not surprisingly, our holdings in 3 - 7 year U.S. Treasuries posted the highest performance, ending the quarter up 2.32%.

## International/Global Portfolio

The international markets took a beating during the third quarter. The MSCI EAFE (our international index) never managed to get into positive territory during the quarter and finally ended down -19.71%. Things were pretty negative, however a number of our positions fared much better than the benchmark. Much of our success came from our CurrencyShares holdings, as well as our investment in Consumer Staples.

Trading during the quarter emphasized over-weighting defensive sectors and reducing volatility. To that end, we reduced exposure in the energy sector due to a significant reduction in oil demand which caused prices to pullback from highs reached in mid-July. Further, the domestic slowdown permeated the international markets causing global commodity prices to fall. As a result, our exposure to that sector of the market was pared back. Asian

markets were hit hard by the domestic slowdown as the US is one of China's largest consumers. We subsequently reduced exposure to Asian markets in an effort to protect against what we believed to be an inevitable downturn.



## Absolute Return Portfolio

Our Absolute Return Strategies are working. As of quarter-end, the S&P 500 was down -20.58% for the year, the MSCI EAFE down -31.07%, and the Lehman Brothers Intermediate Government Credit Index virtually flat at 0.23%. Year to date, the Absolute Return Portfolio has participated in less than 30% of the overall market decline. Finding safe havens with such extreme fluctuations in the broad market can be difficult.

Our focus during the quarter was to stay defensive and heavily weight the Portfolio toward cash and fixed income securities. As of the quarter-end, the Portfolio held approximately 80% fixed income securities, cash and cash equivalents, with the remainder invested in equities. The equity portion of the Portfolio also includes inverse funds, which move opposite of the market that they represent or are indexed to.

Has anything happened we should know about? If there are any changes in your financial situation, investment objectives or specific restrictions, please contact your investment advisor or The Pacific Financial Group, Inc. It is critical to the achievement of your investment goals and the success of our relationship to discuss any changes in your financial needs.

Our clients receive quarterly performance on their accounts. For performance on any of our strategies, please contact your Investment Advisor.

## Income Portfolio

Our Income Strategy is designed to provide an income stream to our clients looking for monthly income and capital preservation. The Portfolio is not benchmarked to an index due to its unique nature; however, it generally has a much higher correlation to fixed income securities rather than equities. As of the quarter end, the Portfolio is invested predominantly in high quality fixed income securities with an emphasis on short to intermediate term maturities. The allocation of fixed income and equities remained static during the quarter, with over 90% of the Portfolio in fixed income and the remainder in equities.

## Tax Managed Portfolio

The Tax Managed Strategy is designed to be a long-term hold which provides shelter for our tax sensitive clients. Changes to the allocation of this Portfolio are infrequent and tend to be smaller adjusting trades rather than large, radical changes. The Portfolio allocation remained unchanged during the quarter however tax loss harvesting is conducted on a case by case basis so there may be trades in individual accounts.

## Socially Responsible Portfolio

This Strategy offers an investment vehicle for our socially conscious clients. As of quarter-end, the Portfolio was invested predominantly in large and medium cap stocks with less emphasis on small cap stocks. This Portfolio also offers exposure to international companies that fall under Morningstar's Socially Conscious category. International exposure as of quarter-end was mostly allocated to the Greater Europe regions, with little exposure to Greater Asia. The overall Portfolio allocation is approximately 6% cash/fixed income and 94% equities.

## HIGHLIGHTS

- A new feature being added to cars can set a speed limit of 80 mph, control how loud music can be played in the car, and check whether seat belts are being used. The feature is aimed primarily at parents of teen drivers, and will be rolled out on many 2010 Ford models.
- The unemployment rate held steady at 6.1% in September, as, although household employment fell 222,000, its impact on the unemployment rate was blunted by a decline in the civilian labor force. Private payrolls fell by 168,000, in September, which was the largest decline in a string of ten consecutive drops, while unemployment rose by 101,000.
- Total commercial paper outstanding fell \$56.4 billion in the week ending October 8th (to \$1.55 trillion), putting the cumulative decline over the last four weeks at \$264.4 billion. Financial company commercial paper outstanding fell \$42.4 billion (down \$174.5 billion over the last four weeks), while asset-backed commercial paper fell \$17.6 billion (down \$73.1 billion over the last four weeks). Nonfinancial commercial paper outstanding rose \$3.6 billion in the week.
- Import prices fell sharply again in September, down 3.0% on a 9.0% plunge in imported petroleum prices. Over the last 12 months, total import prices are still up 14.5% (though this is down from the 18.7% year-over-year increase in August). Nonpetroleum import prices fell 0.9% in September, slowing the year-over-year inflation rate on these prices to 6.5% in September from 7.4% in August.
- The trade deficit narrowed to \$59.1 billion in August from \$61.3 billion in July. Imports fell 2.4% in August, while exports declined by 2.0%. By region, August saw slowing in export growth to China, Europe, Canada and Mexico. Export growth to Brazil, Japan and OPEC countries picked up in August.
- The most recent Fed H.4.1 report (Factors Affecting Reserve Balances of Depository Institutions) was released with a delay. Reserve bank credit (the size of the Fed's balance sheet) grew by \$94.5 billion (6.4%) in the week ended October 8th, following a \$593.8 billion increase in the prior four weeks. Over the last five weeks, reserve bank credit has grown by 77.6%, to \$1.58 trillion.



## What's in the Future?

**F**inancial markets have undergone some severe shocks recently, yet security prices appear to have fallen far beyond levels suggested by fundamentals. Some excesses of the past are being unwound, and have led to, what we believe are, excesses on the downside. Our intent is not to minimize the scale of the problems already experienced or which are still ahead. We do however think that fear is obscuring or distorting a potentially rewarding investment opportunity.

We believe that the market is in a bottoming process. Did we just see it last week? Maybe. Will it come next week? No one knows. Since contemporary markets are so vast and market activity represents so many conclusions and opinions, this can take awhile to develop. Our view is that investors who exit the market will kick themselves in the future for their actions based on fear and panic; and those that stay in the market, and perhaps invest more during this down time will be very happy.

For a market bottom to form, we would agree with a couple of Goldman Sach's recently published assertions that certain thresholds must be passed including: return of normalcy to short-term credit markets, and completion of 3Q earnings season. Certainly there are other metrics as well.

The government has expended significant resources and efforts to

restore confidence in the credit markets. Their efforts should bear fruit, but it is going to take time. It will take awhile to unclog the credit arteries and get institutions (more specifically, the people within them) to start taking risk again. That will require the interconnected web of declining house prices, credit losses, and eroding capital positions at financial intermediaries to wind down. We see that happening by the first half of 2009. Since markets move in anticipation of future expectations however, this would suggest an upturn perhaps even late this year.

The economy has once again become the focus. With the rescue plan signed, and several other actions being implemented by the Treasury, Fed, and global central banks, a shift in attention has taken place toward economic fundamentals. The label of recession is being applied more often, and it has a negative effect on our emotions. The good news is that any recession pronouncement is backward looking. We have all been feeling the effects in our personal lives already, so this is old news. We think the market and economy will improve going forward.

The financial crisis and the increasing risks to economic growth recently prompted the Fed to cut the funds rate 50 basis points to 1½%. It is not unrealistic to expect another comparable move later this year, bringing the funds rate to 1%. The Fed will likely keep the funds rate low and the liquidity throttle wide open for an extended period, until the credit crisis eases and the downside risks to the economy abate. Such an aggressive policy response is

needed to counter the housing and credit shocks. Additionally, the recent plan to purchase financial institution equity appears very constructive to us. This will provide capital directly to the affected entities, and improve their balance sheet capacity much more quickly than buying their illiquid bad assets. Once the plan can be executed, it should help free up the log jam of short term lending.

We are very aware that current conditions are unsettling, and it is difficult to see beyond the fear. No one likes this type of experience. It is worth noting that the latest sell-off has all the markings of a panic, not unlike the type described by Charles Kindleberger in *Manias, Panics, and Crashes*. Viewed from another perspective, historically the time to start buying is when every one else is running for the door. Quoting economist Stephen Roach from a few weeks back, "The most important thing about financial panics is that they are all temporary. They either die of exhaustion or are overwhelmed by the heavy artillery of government policies."

We continue to tread cautiously in today's markets, maintaining our defensive postures while analyzing future opportunities. Indications are for continued choppiness, until a recovery takes hold. It is vitally important that we all avoid making emotional, impetuous decisions, based on ill-considered data. There is light at the end of the tunnel, and it is not the headlight of an oncoming locomotive; it is the light of a brand new day.

We at TPFG stand ready to assist you in any way we can.



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