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September 18, 2008

Financial Meltdown

By now you've surely seen the headlines—Monday, September 15th was the worst day in the stock market since the 9/11 tragedy, with the Dow Jones Industrial Average falling 4.4%, the S&P 500 dropping 4.7% and the NASDAQ down 3.6% on the day. Tuesday saw a decent bounce-back, with the Dow up 1.3%, the S&P 500 up 1.8% and the NASDAQ up 1.3% on the day.

But the hits just keep on coming, with the announcement on Wednesday that American International Group was getting an \$85 billion bailout from the Federal Reserve—giving the government control of an unprecedented 80% of the insurance giant—causing markets to once again plummet, with the Dow, S&P 500 and NASDAQ all nearly matching, or exceeding their Monday drops.

This came on the heels of the Fed's Tuesday announcement that it was standing firm and keeping the fed funds rate unchanged at 2%, an implicit vote of confidence in the economy.

One bright spot was Barclay's \$1.75 billion buyout of the bankrupted Lehman Brothers' U.S. fixed income and equity sales, trading and research and investment banking businesses, saving up to 10,000 jobs in the bargain.

Lehman Brothers' bankruptcy and Merrill Lynch's acquisition signal a return to the free markets ability to sort things out for itself; while painful, this is an essential first step in rebuilding both the financial services system overall and the related layers of confidence that attend it. Such confidence has been badly shaken. And while there's plenty of finger pointing to go around (not the least of which is at the regulators and rating agencies which served as little more than enablers of this debacle), we think the markets are finally putting their finger on the pulse of the problem.

What feels like an ominous backdrop is one—but looking forward, it's worth noting that even some financials (Northern Trust is one example) are having a banner year. Moreover, the consolidation that has been occurring, whether by choice or necessity, will likely create better-run, more efficient financial service companies in the long run. In the meantime, across most other boards, we've still got a healthy crop of well run, profitable, necessary businesses with great intermediate and long-term return potential, made all the more

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attractive by the fact that they're being sold indiscriminately in the face of one sector's perfect storm.

Historical Perspective

Monday's 4.4% drop in the Dow ranks as the 76th worst decline in the Dow in modern times, including the back-to-back 12.8% and 11.7% drops in October of 1929. Since 1929, it ranks as the 68th worst decline for the Dow.

Since World War II we've seen 17 declines greater than 4.4% in the Dow, with more than half of them occurring during the 80s. They often have signaled a terrific time to invest in stocks. On average, the one-year return for the Dow after one of these 17 big declines was 12.8% and the two-year return was 26.4%. In only two instances were the two-year returns negative.

We also have the benefit of investing with some of the best managers in the business, who do an excellent job of picking through the markets' sectors to find the best values for our clients. It's worth noting that in every one of our client portfolios, the managers of the component funds had underweighted the financial sector by 4% to 8% compared to the S&P 500 by the end August.

As we've said in past *Adviser Updates*, these are volatile times, and they are likely here to stay for the foreseeable future. It's not an easy time to be an investor, but a diversified and disciplined approach will prevail over the long-term, as the markets are creating value on a daily basis for our trusted fund managers to snap up.

Fidelity Manager Moves

Fidelity removed a long-time manager from his underperforming charge earlier this month, hoping to turn the fund around, and also giving the fledgling Multi-Manager Group the opportunity to add another portfolio to its nest.

As of September 9th, Lawrence D. Rakers replaced Charles Mangum as manager of Dividend Growth and Advisor Dividend Growth. Rakers will continue to manage VIP Balanced, which he's helmed since 2005. He joined Fidelity in 1993 as an equity research analyst, following the coal, precious metals and restaurant industries in that capacity. Starting in 1995, he did stints with a slew of Select funds: Gold, Precious Metals and Minerals, Paper and Forest Products, Energy, Natural Resources (Advisor version as well), Computers, Technology (Advisor shares too), and also served as the sector leader of Fidelity's natural resources equity research group from 1997 to 1999. He went on to manage Convertible Securities and Balanced (Advisor shares as well, from 2005 on) in 2001 and 2002, respectively. Before joining Fidelity, Rakers worked for seven years as a project engineer for Loral Corporation, starting in 1986.

As a result of Rakers' move to Dividend Growth, the Multi-Manager Group (MMG) has taken over the equity portions of Balanced and Advisor Balanced. The MMG is led by Bob Stansky and consists of John Avery (Industrials and Materials), Matthew Friedman (Energy), Adam Hetnarski (Technology), Steven Kaye (Health Care), Robert Lee (Consumer Staples), John Roth (Consumer Discretionary), Douglas Simmons (Telecommunications Services and Utilities) and Pierre Sorel (Financials). Each manager will be responsible for their specific sectors within the greater portfolio and Stansky will oversee overall sector allocation.

Mangum had managed Dividend Growth for over a decade, getting his start on the fund in 1997, but over the past couple of years, the fund was plagued by underperformance and heavy asset outflows. From the end of 2004, when Dividend Growth counted \$19.4 billion in assets, through August this year, Fidelity saw the fund dwindle to \$9.5 billion. Through August, the fund was down 14.7% year-to-date and had fallen significantly behind its S&P 500 benchmark over three- and five-year periods as well. Fidelity says that it's currently seeking other opportunities for Mangum within the firm. We wish him well, as Dividend Growth served our clients well for a number of years under his guidance (we moved out of the fund early this January, sensing the tide had turned).

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