KAM COMMENTS

KRUSE ASSET MANAGEMENT, LLC

LOOKING BACK

2007 was a difficult year for a variety of reasons. We were in the midst of one of the few housing declines our country has ever seen, the related sub-prime fall-out took down all of the financial stocks, our country has spent hundreds of billions on two wars, the U.S. dollar has been extremely weak, unemployment is up, oil prices peaked at $100 per barrel and under every other stone out pops another economist that is calling for a recession.

On the other hand, the stock market has posted positive returns for the past 5 years, inflation seems to be in check, unemployment is still around historical lows, GDP for the past few quarters was stronger than expected, for the most part company earnings reports have been solid, the global economy is robust, the FED does not believe we are headed towards a recession and the economic problems have a way of working out through the complex interactions of free markets.

2007 was a bumpy ride and the future promises more excitement, but in the long run a balanced, disciplined approached to investing will weather even the worst of storms.

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In this issue:

Did you know?

* Looking at the 72-period between 1927 and 1999, the broad indexes returned 9% more a year on average under a Democratic president versus a Republican president.
* Between 1896 through 2001, volatility is lower during Democratic presidencies than during Republican periods as well.

FINANCIAL BEHAVIOR BASICS

Let's say you're on your way to the theater. In your right pocket you have your tickets valued at $100. In your left pocket you have a $100 bill.

As you're walking into the theater you put your hands in your pockets and realize that you have your tickets, but you have lost your $100.

Question: Do you still go to the theater?

Most people would say, "Of course I go to the theater. The events are unrelated."

Now, let's say you reach into your pockets and you realize that you no longer have the tickets, but you do have your $100.

Question: Do you still go to the theater?

Most people say, "That depends…"

Buying the tickets again puts you in the same situation as in the first case, so why does it feel like a different scenario?

"Mental Accounting" states that people tend to place their expenditures into different "buckets." These semi-arbitrary categorizations change peoples' perception of situations, and often leads people to make different decisions depending on the path or process that just occurred.

Relating to the investment world, if you have made a $100 investment that is now worth $80, you may wish to sell to cut your losses. On the other hand, if you weren't invested and saw that same investment drop from $100 to $80, you may want to buy. However, determining the value of the investment today has little to do with your own personal involvement yesterday.

Evaluating your investments independent of your past will lead you to better decisions.

KRUSE ASSET MANAGEMENT, LLC

J. Stuart Kruse, CFA
2717 N. Lehmann, Unit 5
Chicago, IL 60614

Phone: 312-371-1650
Fax: 312-264-4557
Stuart@KruseAssetManagement.com

Improving Your Odds of Reaching Your Goals

"Short-term moves in the market are like stories told by an idiot: full of sound and fury, but they tells us nothing."

— Bogle's use of Shakespeare

CASH FLOW 101

I often hear people saying that one of their current goals is to pay off their house in the next "X" number of year (say 10), so they can be debt free. And while this sounds like a prudent thing to do, if you are a taking a long-term view, there can be a better paths to take.

Let's look at this example: An investor has a mortgage out on his house at a rate of 6.5% and his marginal tax rate is 25%. In general all of that interest is deductible, so the **net** interest rate that investor is paying on his mortgage is 6.5% X (1-25%) = 4.875%.

In practical terms, every dollar that an investors puts towards that mortgage, he is locking in a return of that net interest rate. In other words he has guaranteed a "return" of 4.875% on his money.

What if the investor took those extra dollars and put them in a segregated investment account? Well, even at the lowest risk asset allocation (80% bonds, 20% stocks), an investor could reasonably expect to make 5-6% on his money over that 10-year period (more with a more aggressive allocation).

The difference between what the investors will make on the money versus what he is paying to use that money is what that investor gets to keep, and as my father says, *"It is not how much you make, but how much you keep…"* Banks make their living off of these "spreads" and there is no reason why a homeowner with a solid asset base shouldn't make that money too.

If at any point the scenario changes (like the investor losses his job, etc.) the segregated account could always be used to pay down (or pay off) the mortgage. However, since the investor still controls the money, it is still his option to do with it what he wishes — not the lender's.

Staying in control of your own money gives you more options and more freedom to do what you want, under any scenario.

SOUND PORTFOLIO CONSTRUCTION

Last quarter we discussed Diversification, the cornerstone of Modern Portfolio Theory. However, as time passes, some sectors display higher relative strength and others weaker. This movement changes your asset allocation and, therefore, the risk of your portfolio.

And if history has taught us anything, it has taught us that nothing remains in favor all the time. Today's hot sector may crash tomorrow and an out-of-favor investment now could be your biggest winner a year later.

Since nobody really knows which sectors will turn around, and more importantly, they don't know when that change will occur, it is critical to rebalance your portfolio periodically.

Unfortunately, this often requires the movement of funds from an investment that was probably making you the most money to the others that could be under water.

In spite of this action being counter-intuitive to what you feel like you ought to be doing, rebalancing has been shown to reduce your risk and improve your returns over time.