

PART II
YOUR BRAND NEW PORTFOLIO

Hi Everyone,

This letter/email is many pages long due to the number of charts used.

I am so very pleased to announce to you your new portfolio of funds. Though several months to develop, I trust you will agree it is worth the time and effort taken to select these funds*. They represent and are faithful to our commitment to you of balancing risk and safety with a sound strategy.

First though, before reviewing the charts, I want to illustrate once again why we have not been in the market to this point. Also important to note: Any investors that have been in the market from January 1, 2009 – May 29, 2009 have not had gains, all they have done to this point is make back the 27.4% loses they had from January '09 through March 10, 2009.

This is a hypothetical illustration of what happens to portfolio values when markets fall and your money along with it.

In this illustration we are using an example of \$100,000. The market falls 50% plus as it did from 01/01/2008 – 03/09/2009.

\$100,000	Investment
<u>-50%</u>	Market falls 50%
\$50,000	Your balance
<u>+50%</u>	Market goes up 50%
\$75,000	New Balance

Many people have the impression that when the market goes down 50% then goes up 50% that they have their original investment back. But that is a false conclusion.

In this illustration the market would actually need to go up 100% in order to get back the original investment.

And if you add to this illustration what would have happened if you were taking a 6% yearly income that was paid monthly? The market would need to go up approximately 151.6% in order for investors to get back to their original investment of \$100,000.

And when do you think that will happen?

The above hypothetical illustration demonstrates the most important reason why we *must not* take this kind of risk but invest with *caution* during this very unstable period in our economy.

But make no mistake about it; I understand that we *must* invest. So how are we going to invest with as little risk as possible? Remember the saying which has been our motto during this unstable market: "Hope for the best, but prepare for the worst" ... just in case. Understand what the *REAL* worst-case scenario could mean for your investments ... then hope it never happens.

I have been watching and studying this market day and night, literally. I have put model after model together and have been watching some of these models since last July to see how they would react to different market conditions. I feel I have put together an excellent mix for us; one that will make money while combating the risk during these unstable times.

Remember, all of your money to this point has been kept safe for you in the money market. That avoided the carnage last year and the 27.4% decline in the first quarter of this year; so we first had to purchase funds again. This is the reason that you have seen more confirmation statements from Fidelity than usual as well as transaction fees. Additionally, because we are taking such great pains not to put your money at undo risk, we have had to purchase a couple of extra funds serving as an insurance policy to protect your money.

Following are some charts to illustrate what we have purchased and why; and how we will be able to make money for you safely.

The first chart is a chart of an ETF (Exchange Traded Funds) symbol SH that is an inverse S&P 500 fund. In other words, this ETF will go *down* when the S&P 500 goes *up* and most important, it will go *up* when the market *falls*.

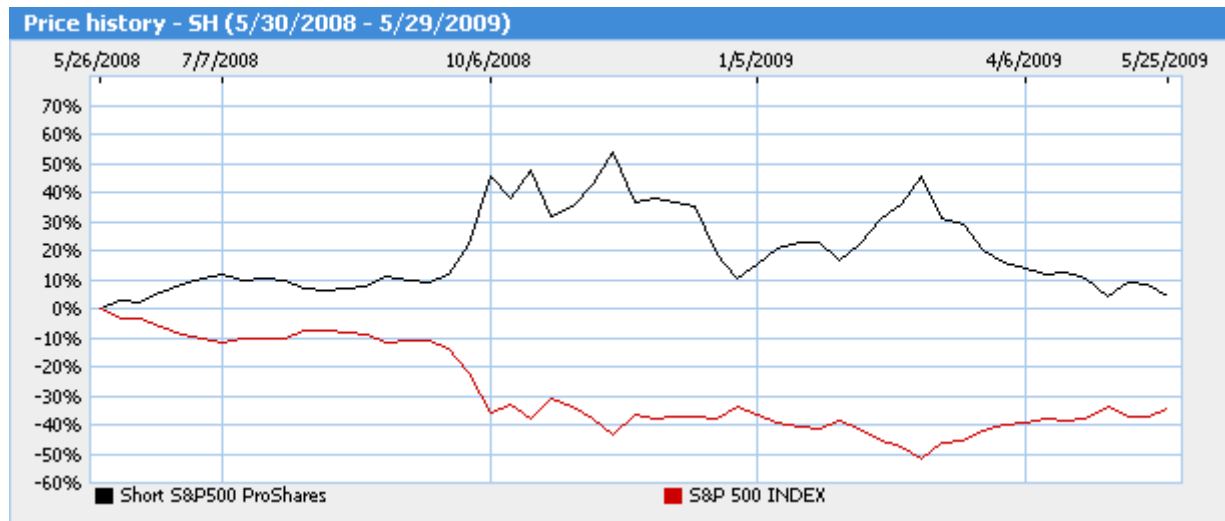


Chart 2 below is a chart of a Brazilian ETF symbol EWZ that follows the market. When the market goes *up* EWZ will go *up* and when the market goes *down* EWZ will go *down*. Note: Some clients have FYI which is a China ETF instead but works just the same way as EWZ.

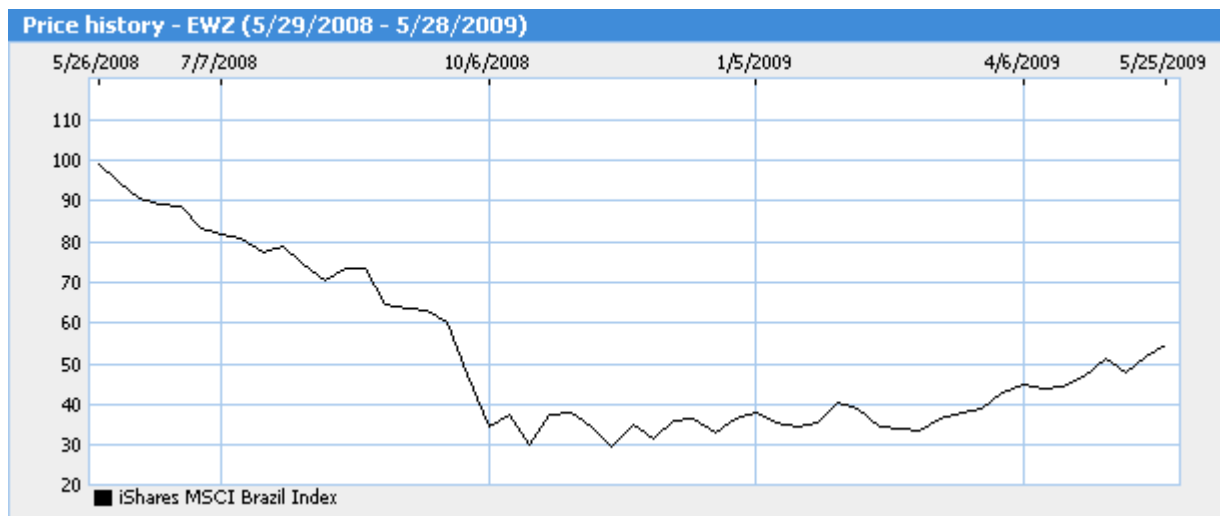


Chart 3 puts these two funds together for you. Notice how they *off-set* each other.

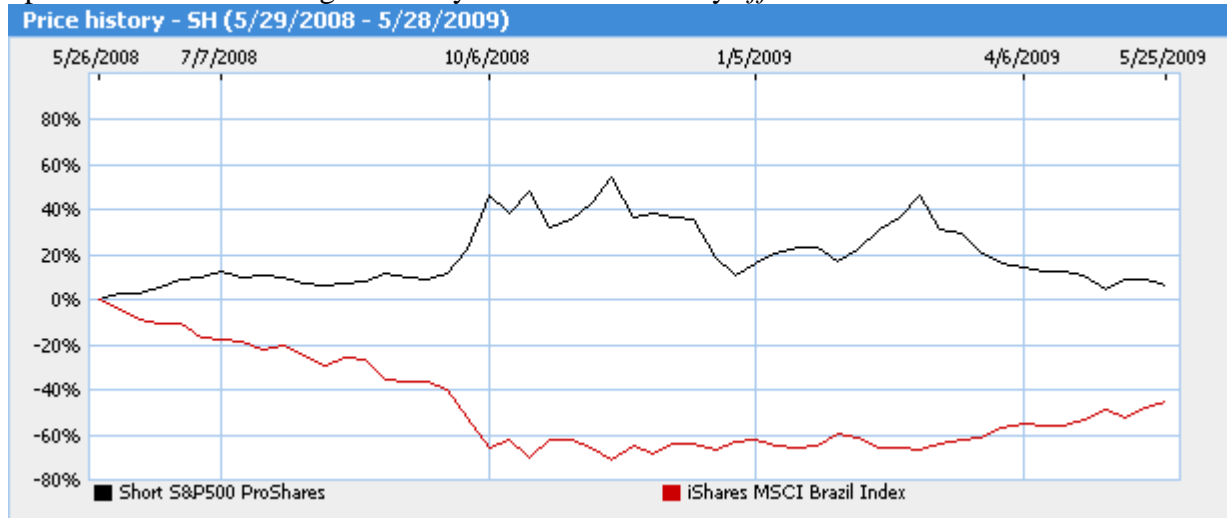


Chart 4 is a chart of an ETF symbol SEF that is an inverse financials fund. When banks and financial institutions go *up* this fund will go down. Again, most important is when banks and financials *fall*, this fund will go *up*.

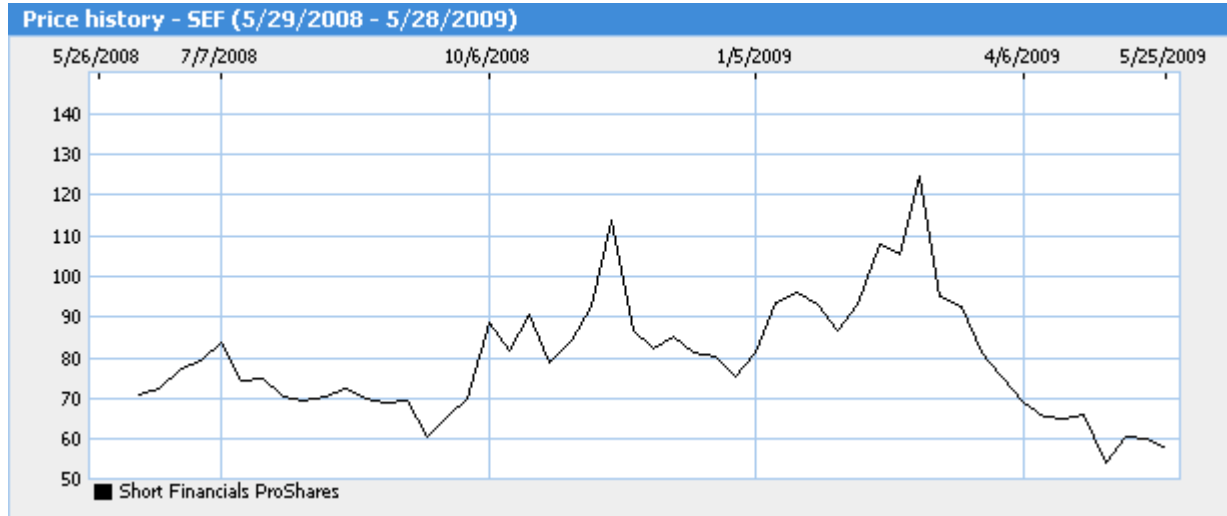


Chart 5 is a chart of an ETF symbol UYG this fund is an Ultra Financials Fund. It will *move twice what the financials move up or down*.

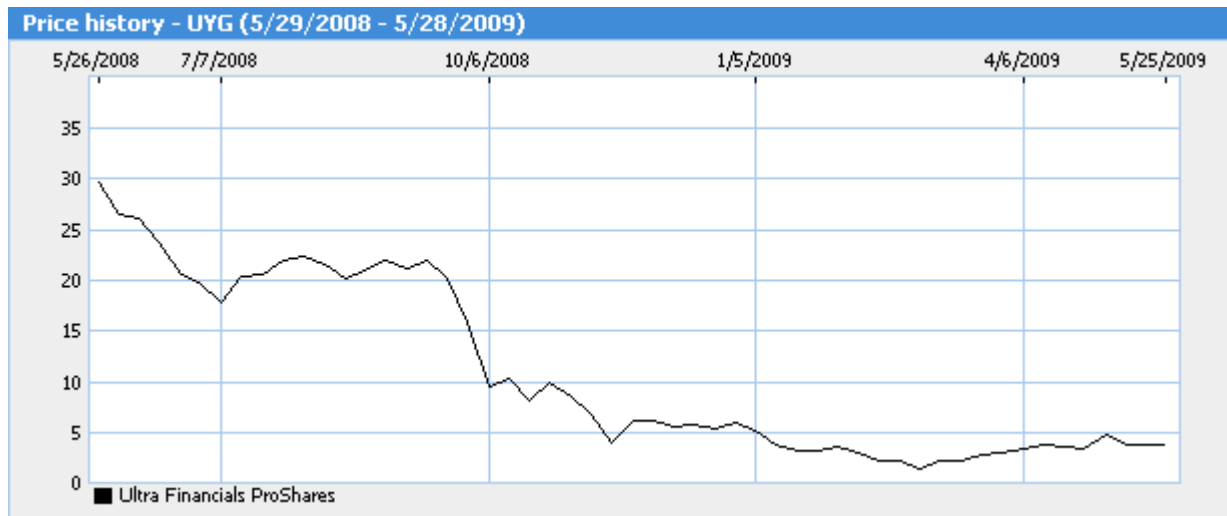
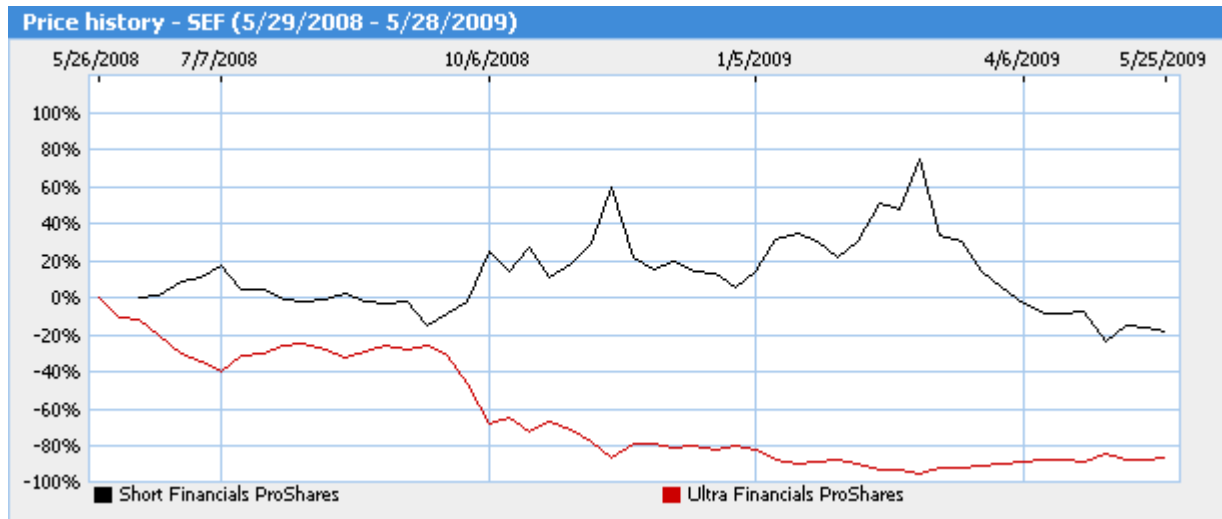


Chart 6: Once again puts these two funds together. Again notice how they *off-set* each other.



Now a question you may have is, if they off-set each other how do we make money. Let me explain.

While the market is going up EWZ, FXI and UYG are also going higher. To protect their gains we are following them up with a trailing stop loss. If for instance, EWZ and FXI go up \$5 to \$10 a share or more than what we originally purchased them at, and then the market begins to fall drastically, these (3) funds will hit their stop losses and sell; keeping most of the profits. Conversely, SH and SEF will soar, making us more money. Of course then we will be following these up with trailing stop losses as well.

I think it's a great plan, and our models have proved it.

We also have Gold, symbol GLD and Gold Mining, symbol EGO as well as Silver, symbol SLV and Oil symbol XLE in our portfolios too. These investments are all doing very well currently and should continue to do well if and when the market falls or inflation rises. Note: No one will have all (4) of these in their portfolio because of the transaction fees involved in having all (4).

Some of our clients also have an ETF that follows the India Index, which is doing quite well currently. Its symbol is PIN.

Now not to confuse you even more but the next two charts are what *will purchased after* the market corrects or falls. There is little doubt in my mind that the market will go back and retest the March lows sometime in June.

Chart 1 is an income fund that pays a 10% dividend. Western Asset Worldwide Income Fund symbol SBW is one fund we are considering purchasing after the market's correction. WAWIF has been around a very long time. It has paid as much as 12% when inflation was out of sight but for the last several years it has paid a 10% dividend.



Dividends are great because they are *paid on* how many shares you have *not* on what the price per share is. So if the share price goes up or if the share price falls it does not affect the dividend. As long as we do not sell any shares or the company doesn't lower the dividend it will continue to pay the 10% dividend per year.

However, as you can see in the chart above, you can lose value if the price per share drops like it did in Oct. '08 (*although it did quickly bounce back*) and as I have illustrated in this email, we can not afford to have that happen to our portfolios. But if we hold onto the ETF, SH it will *off-set* SBW nicely as Chart 2 illustrates. This way we can get the 10% dividend with very little risk to loss of value.

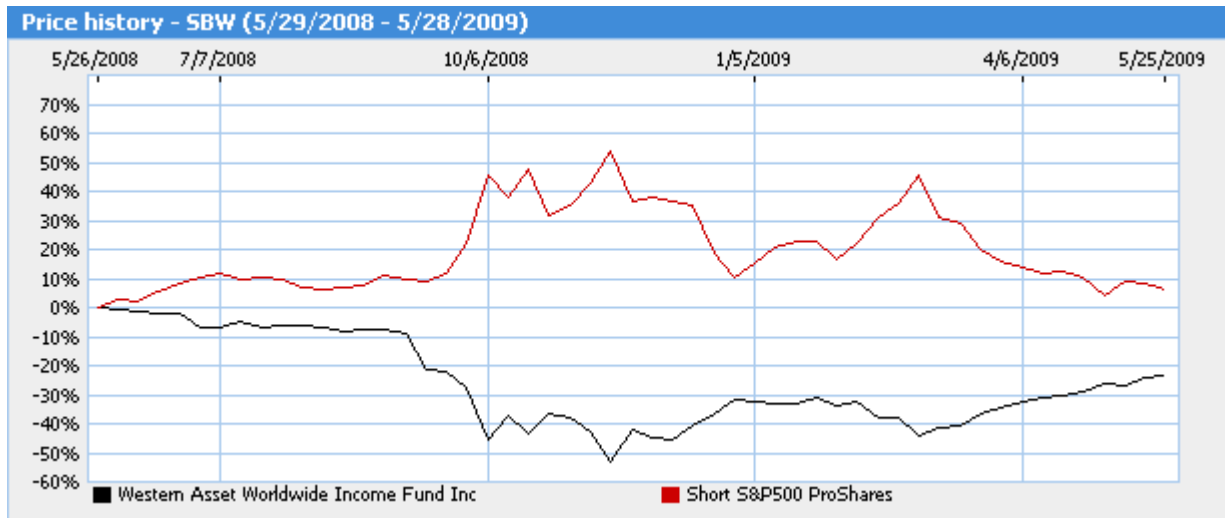
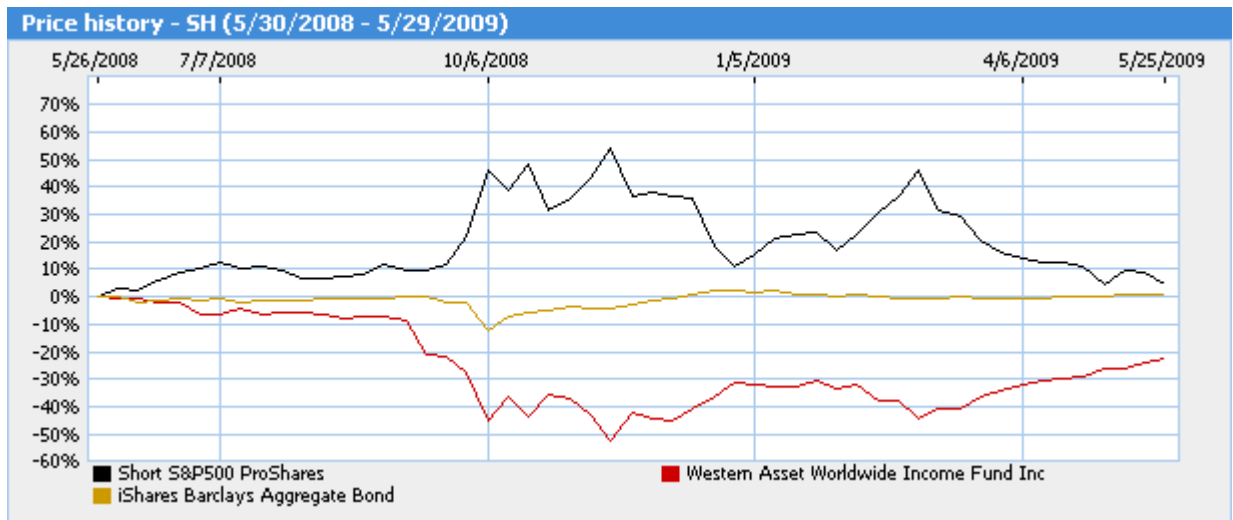


Chart 9 shows one last fund which is represented by the gold line on the chart. AGG is a symbol for an Aggregate Bond Fund. As you see by looking at the chart, it is pretty much a straight line. One blip in Oct '08 when investors were fearing the worse but it then bounced right back up and has stayed a steady eddy ever since. This bond pays a 4.47% dividend which will help our portfolios earn a nice safe return.



Shari and I believe that this market and economy still has a long way to go before they are both healthy again. Jobless Claims reports each week are still showing horrendous amount of people losing jobs. U.S. real estate prices are falling off a cliff, taking homeowners' equity with them. The stock market currently is at a crucial juncture where it now has a bit more than a 50/50 chance of going back and checking March's lows; if it does that would mean as much as a 30% drop or more from where it is at today.

We have built a portfolio that allows us all to *sleep at night* and still be in the market; riding it up for now. But if and when the market does fall, we are protected and will make money on the downside as well. I know you will agree with Shari and I that this is darn smart investing.

Talk to you soon,

Valerie Holcomb, President
 Shari Hooper, Senior Vice President
 Cascade Financial Group

*The selection of funds was based on the amount of money invested. We still want to keep a good amount of money in the money market for safe keeping and to be used after the market falls or corrects. Therefore fewer funds have been used for clients with smaller amounts invested with us. Clients with less than \$40,000 will have an entirely different investment strategy used and therefore this email/letter will not apply. A separate letter will be sent to you very soon.

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Hello CFG clients,

Brian Harris here, tax manager of CFG Tax & Accounting. I have come to know many of you by doing your tax returns over the past few years; if I don't do your tax returns, you may have heard me speak at one of the recent client seminars. Valerie has offered me this wonderful opportunity to contribute to her weekly email updates to you folks, which I have graciously accepted!

As a precursor, you will find my commentaries to be widely varied; sometimes I'll take a "just the facts" approach, at other times I'll be in a subjective commentary mood. Still other times, I will borrow a published article that I feel is timely and/or may not get the mainstream exposure that it is rightly due. In any event, I trust you'll find my emails as informative and as useful as that which you've come to expect from Valerie.

Today's email will be a combination all three categories; a just-the-facts borrowed article with some subjective commentary. Val, Shari and I read well over 100 articles a week ranging from mainstream to the more obscure; all in an effort to get to the bottom line truth. Too often lately, however, it seems the mainstream media is either hiding/obscuring the truth or their journalists are compensated on the sheer volume of articles they write so they just don't "dig in". Or maybe the media outlets themselves are politically steered into the perspective from which they write. In any event, we feel it is our duty to you to sift through and find the relevant data that has the potential to save or make you money in these turbulent times.

I'll start with the subjective commentary first, because as many of you know I spent 20-years in the banking industry. And the article (actually it's a publication) I'm borrowing is the most recent FDIC Quarterly Banking report dated 03/31/09 ([link here](#)). While this quarterly report contains a significant amount of useful data, I am focusing on the number of "problem" banks buried in this report. While the names of the problem Banks are not revealed, the number of problem Banks is reported. For perspective, I have compiled the following chart from the quarterly data presented in these reports going back to 2001:

REPORTING PERIOD	# OF FDIC INSURED BANKS REPORTING	# OF PROBLEM BANKS	INCREASE (DECREASE)	% OF PROBLEM BANKS	BANK FAILURES	FOOTNOTES
3/30/2001	8,237	78	2	0.95	0	-1
6/30/2001	8,178	80	2	0.98	1	-2
9/30/2001	8,149	74	-6	0.91	1	-3
12/31/2001	8,080	95	21	1.18	0	-4
3/31/2002	8,005	102	7	1.27	6	-5
6/30/2002	7,966	115	13	1.44	1	-6
9/30/2002	7,933	126	11	1.59	2	-7
12/31/2002	9,354	136	10	1.45	2	-8
3/31/2003	9,314	129	-7	1.39	1	
6/30/2003	9,267	125	-4	1.35	1	
9/30/2003	9,236	116	-9	1.26	0	
12/31/2003	9,182	116	0	1.26	1	
3/31/2004	9,116	114	-2	1.25	3	
6/30/2004	9,079	102	-12	1.12	1	
9/30/2004	9,025	95	-7	1.05	0	
12/31/2004	8,975	80	-15	0.89	0	
3/31/2005	8,930	79	-1	0.88	0	
6/30/2005	8,867	74	-5	0.83	0	
9/30/2005	8,853	68	-6	0.77	0	-9
12/31/2005	8,832	52	-16	0.59	0	-10
3/31/2006	8,790	48	-4	0.55	0	
6/30/2006	8,778	50	2	0.57	0	
9/30/2006	8,743	47	-3	0.54	0	
12/31/2006	8,681	50	3	0.58	0	
3/31/2007	8,650	53	3	0.61	1	

6/30/2007	8,615	61	8	0.71	0	
9/30/2007	8,560	65	4	0.76	1	-11
12/31/2007	8,533	76	11	0.89	1	-12
3/31/2008	8,494	90	14	1.06	2	-13
6/30/2008	8,451	117	27	1.38	2	-14
9/30/2008	8,384	171	54	2.04	9	-15
12/31/2008	8,305	252	81	3.03	12	-16
3/31/2009	8,246	305	53	3.7	21	-17

- (1) Gains on security sales lift industry profits to new record, despite decline in operating earnings Troubled Commercial & Industry loans continue to grow
- (2) Gains on security sales buoy profits; problems worsen in large Banks' commercial loans Charge-offs increase in credit card portfolios
- (3) Quarterly loss provisions reach highest level in more than 10-years Asset-quality indicators show further deterioration
- (4) Best 4th quarter ever helps full-year earnings to record level; Number and assets of "problem" banks surge during the qtr
- (5) Bank earnings rise to new record of \$21.7 billion; asset-quality weaknesses continue to grow.
- (6) Earnings climb to record-high \$23.4 billion; troubled commercial & industrial loans continue to rise
- (7) Gains on securities sales help keep earnings near record level; asset-quality problems continue to grow at large banks
- (8) Fourth-quarter earnings are third highest ever; largest number of Bank failures (11) in a year since 1994
- (9) Lowest total of problem banks since compiling data (36 yrs). Longest streak w/o a failure since 08/96 - 10/97
- (10) The most quarters w/o a failure since the inception of FDIC (1933)
- (11) Credit quality problems drag down earnings; real estate mortgage delinquencies skyrocket
- (12) Non-current rate on mortgages reaches new high; net charge-offs reach 5-yr high
- (13) Industry earnings decline 46% from a year earlier; troubled loans accumulate in RE portfolios
- (14) Industry income falls to \$5 billion; Quarterly loss provisions surpass \$50 billion; asset quality indicators continue to deteriorate
- (15) Highest quarterly failure since 1993 when 16 failed; asset quality problems continue to depress earnings
- (16) Industry posts \$32 billion loss (first quarterly loss since 1990); loan loss provisions/goodwill write downs/trading losses outstrip revenues; asset quality indicators show further deterioration
- (17) Charge-offs of \$37.8 billion only slightly less than 4th qtr charge-offs of \$38.5 billion; charge-offs did not stem non-current loans which saw the largest quarterly increase (\$59 billion) & at highest rate since 1991; largest number of failures since 1992;

First, let me explain how to use the FDIC's report. Once you click on the blue link provided above, use the drop down box where it says "Report Date:" Choose the quarter that you wish to review then click the "Complete QBP" link in blue below the drop down box wherein the complete report will be opened. Typically, the first 3-4 pages provide written narrative which I find to be extremely informative. The section that outlines the problem Banks is the last paragraph of written narrative before all the figures/numbers are presented (typically page 3 or 4).

SOME TELLING SIGNS

The chart I put together from these quarterly reports reveals some interesting trends; the 2nd column in the chart reflects how the number of Banks reporting is declining. This reflects a trend that began in the late 90's wherein the banking industry began consolidating (i.e. mergers and acquisitions). This is actually a good thing since the United States has had way too many banks for its size. By contrast, Germany has 2,400 banks; Russia has 1,350, India has 282, Canada has 60 . . . so you can see the U.S. has by far the greatest number of banks in the world. This must be a profitable business here in the U.S. eh?

The 3rd column shows the number of problem Banks and the 4th column shows the net increase (decrease) from the prior quarter. As you can see from these numbers, beginning in 06/08, the number of problem Banks crossed the 100 mark for the first time since the period from 2002-2004 which was during the last U.S.

recession. More interestingly, the number of problem banks began rising in 12/06. While I've not dug into any longer term patterns on this, the data from these reports certainly could have been an early indicator that something was amiss in our economy as early as 12/06, a full year before The National Bureau of Economic Research officially deemed 12/07 as the start of the current recession. I have footnoted some highlights of the written narrative taken from several of the quarterly reports which I also found very revealing. During the 2001 recession, the number of problem Banks was rising; additionally, footnotes 1-8 outline how the Banks problem loans were increasing, but their earnings or profits were also increasing . . . more on this later.

SO WHERE ARE WE NOW?

The concerning issue here is that **the number of problem Banks keeps rising and has hit 305 in the 1st quarter of this year, the highest level since 1991**. Maybe even more startling, we have come across information from lesser known but very reliable sources that the true number of Banks that **should** be on this list is over 1,000. These sources use a Bank solvency formula called the *Texas Ratio* to determine the health of a Bank. This [formula](#) grew out of the Texas savings & loan crisis of the 1980's and reveals that if a Bank's Texas Ratio is 100% or above, it is likely to fail. What is interesting about this formula is that two recently failed banks, IndyMac Bank and Washington Mutual Bank had Texas Ratios of 140% and 119% respectively, however neither Bank was on the FDIC's problem list. Another Bank, Wachovia, nearly failed before it was bought by Wells Fargo Bank; its last known calculated Texas Ratio was 86% but it too was not on the FDIC's problem list.

One of the components for both the FDIC's problem list and the Texas Ratio formula is the amount of a Bank's capital or equity. As you may have read lately, government TARP funds have been forced upon many Banks, funds which would be classified into a Bank's overall equity capital. Additionally, Banks have been on a race to raise additional equity capital to get out of their TARP commitments, so they have been bringing new public stock offerings to the market. As a result of increased equity capital, their Texas Ratio will drop. While this may help to keep a Bank afloat for awhile, it does not address the real problem of a continuing rise in bad loans. As unemployment continues to rise, more and more loans (i.e. credit cards, auto loans, home mortgages) continue to go delinquent; hence causing the Texas Ratios to rise again. So, as you can see, the TARP funds and additional public stock offerings may offer the Banks short-term band-aid fixes, but these funds do not address the underlying fundamental problems that will result from continued bad loans.

As footnote 17 highlights, **the amount of noncurrent (i.e. delinquent) loans reported in 03/09 saw the largest quarterly increase in the three years that noncurrent loans have been rising**. Remember, first loans become noncurrent/delinquent before they are deemed "bad loans" and are written off. **In addition, the rate of increase in delinquencies appears to be increasing**. This is terrible news in that the Banks' newly acquired TARP or newly raised equity capital will be reduced as this pipeline of noncurrent loans starts going bad and has to be written off. This could lead to more Banks being added to the problem list, more failures, and possibly a second TARP program being suggested by our elected leaders.

As I mentioned earlier, during the 2001 recession the number of problem Banks was on the rise; the footnotes reported an increasing trend of problem loans but Bank earnings were also rising. Ultimately, what was happening was the Federal Reserve's (via Alan Greenspan) slashing of interest rates coupled with Congress' push for Banks to generate loans, primary home mortgage loans. So it seems that the economy was trying to correct during this time period, but these two key events prevented this self-correcting mechanism from kicking in and, instead, they fueled the economy and prolonged the correcting process until 2008 . . . only now we have even further to correct and more pain to endure.

SO, WHAT NEXT?

Many economists say the key to economic recovery is stabilization within the banking system. Other economists say it is the consumer that will lead the economic recovery. Still others will say that if businesses cannot get working capital loans from Banks to keep their operations running, then layoffs will continue to take place in an effort to reduce expenses. You can see how all three of these (banking, businesses and consumers) are so closely intertwined. When consumers feel the threat of being laid off is gone and their job is secure, their personal financial situation stabilizes and they stop defaulting on their personal loans. This behavior stems the tide of defaulting loans at the banks, thereby stabilizing the Bank's balance sheet and the Bank is more apt to loan again to both businesses and consumers.

Unfortunately, in spite of the sporadic “green shoots” being mentioned in the mainstream media, I just don’t see anything shaping up fundamentally in our economy that would stem the tide for banks to lend, businesses to borrow or consumers to spend. The Federal Reserve has slashed interest rates to zero, however Banks have tightened their lending standards and Congress cannot push the Banks this time to make loans. Given the fact that we are in a global recession, coupled with the large reduction in the US manufacturing base, other countries are not demanding the few goods the U.S. still produces, so exports cannot pull us out of this. As optimistic a person as I am, I truly believe we are several quarters (if not years) from a true economic recovery.

The FDIC’s Quarterly Banking Profile is released 50-60 days after the end of a quarter. Since the Banks will be reporting their 06/09 quarterly earnings to the market before this report is released, we will have a precursor to where the Banks are sitting before the report comes out. In any event, I’ll be sure to update you when the next quarterly report comes out sometime toward the end of August. It will be entertaining to follow this report over the quarters to come and see how much insight we can glean from its findings.

Val, Shari and Brian
Cascade Financial Group

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