



October 1, 2008

Dow: 10,635

CHAOS

"The infinity of space or formless matter supposed to have preceded the creation of the universe." That's from Webster's dictionary, and that's where we are today as we are creating the next economic and stock market recovery. Out of chaos comes opportunity and order. Certainly many people have suffered and more will suffer before this is resolved. History should teach us about financial crises, but it doesn't seem to. From the tulip bulb mania in seventeenth century Holland, to the stock market crash in 1929, to the present day crisis, we seem to learn very little. In Holland people were selling everything they owned (including their homes) to buy tulip bulbs that they speculated would continue to increase in value. During the summer of 1929, many common stocks were selling in excess of 100 times earnings and investors were borrowing money to buy stock on 10% margin. We all know how that ended. For the last ten years the housing market exploded and investors were flipping houses to make a quick profit. Financial institutions were making questionable loans, Congress was ignoring the rapid growth of the quasi-government agencies (Fannie Mae and Freddie Mac), and potential buyers in their zeal to get into a house were exaggerating their financial records.

Like any financial crisis, this one did not happen overnight. The seed was probably planted back in 1977 when Congress passed the Community Reinvestment Act (CRA). At the time, this was a rather benign act that was intended to stimulate business investment in the inner cities and among minorities. The act was updated in 1994, and homeowners that previously didn't qualify were made eligible for government backed loans. Congress also passed laws in the 1990s to allow Fannie and Freddie to enter the subprime market for the first time. By the late 1990s, the stage was set and the housing boom was on. The boom was further fueled by politicians, who now pushed banks to make more subprime loans, and, in return, they would not stop banks from opening new branches or buying up smaller institutions. Then we had a period of extremely low interest rates that put more unqualified buyers into houses, and allowed financial engineers to create all forms of risky investments from CMOs (Collateralized Mortgage Obligations) to CDOs (Collateralized Debt Obligations). These instruments were then leveraged up to 30-40 times to create more debt and risk. Like any financial bubble, the market wakes up one morning and decides that something is wrong here, and the house of cards begins to tumble.

(CONTINUED ON REVERSE SIDE)

So, what's the solution and how long will it take? We understand that Henry Paulson, Secretary of the Treasury, submitted a 3-1/2 page strategy that basically would involve a \$700 billion loan from the government (taxpayers) that would be used to buy up mortgage and other debt at distressed prices and to hold these debts until the markets recover and potentially make a profit. Mr. Paulson was the CEO at Goldman Sachs in his previous job, and although he may not directly be a part of the problem, he understands it, so why not make him a part of the solution. Congress, on the other hand, submitted a 106 page bailout plan that couldn't pass the House. As of this writing, the bill with addendums passed the Senate and is on its way back to the House. The longer Congress dithers on this, the more complicated the Final bill will be. Sometimes the cure is worse than the disease.

In the meantime, Americans are still going to work and in general getting on with their lives. The unemployment rate is at 6.1%, almost a fifty year average. It will probably increase however, as employers are reluctant to expand. Second quarter GDP numbers were revised down to 2.8%. Third quarter numbers will no doubt be lower and could even be negative. However, as much as the media would have us believe we are in a depression, we are not even in a recession based on GDP. We do expect more bad news when third quarter economic data and corporate earnings reports are out, and we are hopeful that will be the beginning of the beginning.

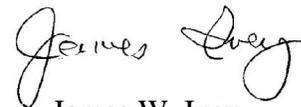
We have been accused in the past of wearing rose-colored glasses. This is not true as we try to be pragmatic when it comes to investing; however, we do tend to see the glass as half-full all the time. We (USA) have been through many troubling times in our 230+ years of existence, starting with our struggle for independence when half the population didn't believe we would survive. But, survive we did and prospered to become arguably the greatest nation in this history of civilization. We will survive this crisis and become much stronger because of it.

Random thought for October: "We could certainly slow the aging process down if it had to work its way through Congress".

Will Rogers



Michael L. Dana
Chairman of the Board



James W. Ivey
President

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