INVESTMENT STRATEGY UPDATE

September 28, 2007

Beautiful credit! The foundation of modern society. Who shall say that this is not the golden age of mutual trust, of unlimited reliance upon human promises? That is a peculiar condition of society which…puts into the mouth of a distinguished speculator in lands and mines this remark: "I wasn't worth a cent two years ago, and now I owe two millions of dollars."
The Gilded Age, *Mark Twain*

WHAT WERE THEY THINKING?

History repeats itself, only differently. So said Robert Farrell, the highly respected, now retired, Merrill Lynch market tactician. Indeed, in contemplating the current credit squeeze and the manner in which it developed, it seems that history has repeated itself. While the particulars of the sub-prime debt meltdown have not been seen before, the current cycle of greed, fear, and downright stupidity seems all too familiar. The primary players in this still unfolding drama are the home buyers, the mortgage banks and brokers, Wall Street's investment banks, the credit rating agencies, and of course the sub-prime debt investors who must once again be asking themselves, "What was I thinking?"

A significant portion of the sub-prime borrowers were lured by the American dream of home ownership. But many others were motivated by the desire to speculate on the continuing trend of rising real estate values. We use the term "speculate" rather than "invest" because in the rising-price environment of recent years, residential real estate has progressively become a much less attractive investment when viewed in terms of rental income returns. For many of the residential rental properties purchased in this cycle, the monthly rent received is less than the mortgage payment. In those instances, the only way to profit is by a quick resale at a higher price, which may no longer be possible. Lax lending standards and adjustable-rate mortgages with unrealistically low introductory rates helped to facilitate even the most marginal transactions.

In hindsight, the mortgage lenders had little reason to concern themselves with credit risk. Unlike the period preceding the real estate downturn of the early 1990s, this time residential real estate lenders actively sold off the loans they originated. With the help of Wall Street, mortgages were re-packaged into collateralized debt obligations (CDOs), as this incarnation of the structured products market has come to be known. These securities were then separated into various risk pools (tranches), rated by the credit rating agencies, and sold to investors seeking a particular level of yield and risk. In this cycle, the mortgage lenders were essentially conduits between the home buyers on the one side and the loan buyers on the other. Like the mortgage brokers, theirs was now a transaction-based business.

The role of Wall Street as the packager of CDOs is no surprise. Collateralized mortgage obligations, collateralized bond obligations, and other asset-backed securities have been around since the 1980s. The difference this time was that instead of grouping large numbers of similar assets together (e.g. credit-card receivables), CDOs held a wide variety of assets as collateral (e.g. prime and sub-prime mortgages, corporate bonds, and automobile loans). Wall Street's firms have a long and storied history of manufacturing and marketing whatever products investors desired. Their business is to profit, and by packaging and marketing CDOs they did so handsomely.

The credit rating agencies were enlisted by Wall Street to legitimize these new CDOs. Essentially, these agencies get paid to assess and monitor the credit worthiness of debt instruments. Ultimately, theirs is also a transaction-based business. They rate, they get paid. Unfortunately, in the complicated and often confusing CDO arena, the quality of their work was less than stellar.

And what about the primary losers in the recent meltdown, the institutional and individual CDO tranche holders? Were they delusional? Of course, they often are. Pension and profit sharing funds invest under a set of guidelines that almost always allows for the purchase and retention of investment-grade debt instruments. Retirement fund managers purchased CDOs because, in a low interest-rate environment, the higher rated CDO tranches provided very favorable returns, given the implied risk level. Banking institutions purchased CDOs, as well. Under the Basel II Accord, the international banking standard by which regulators establish reserve requirements, banks are required to hold only 20% reserves on their holdings of AAA to AA- rated debt instruments, 50% reserves on A+ to A-, and 100% on BBB+ to BB-. So both domestic and foreign banks could profit significantly by paying low interest rates to depositors, while leveraging those deposits to buy as much as five times that amount of the highly rated, higher-yielding CDOs. Hedge funds, which are subject to far less regulation, could take the same practice to an extreme level.

Sell! To whom?

Interestingly, the subsequent meltdown in the sub-prime debt market was not a function of borrower defaults, although defaults had been rising. Rather, it was a "crisis of confidence" to which we referred in our August 16, *Interim Update*. On July 20, 2007, with a rising realization of the potential default risk in the sub-prime mortgage market, Moody's downgraded hundreds of securities that were backed by, among other things, sub-prime loans. Standard & Poor's followed suit two days later. The moves jolted the financial markets. As a result of the downgrades, some CDOs were no longer qualified as acceptable portfolio holdings by the pension funds or for favorable reserve accounting at the banks.

All of a sudden, nearly everyone who held sub-prime debt wanted to significantly reduce their holdings. Unfortunately, there were so many more sellers than buyers that for many of the sub-prime tranches there was no market at all. Consequently, there was no ability to sell or even to value those holdings. And so it was that several of the institutional managers who had invested in CDOs had to freeze customer redemptions. In the days that followed,

more than a few global banking institutions reported capital inadequacies, and several large hedge funds reported sizable losses. The stock market declined sharply, as well. The Dow Jones Industrial Average, which on July 19th had achieved its first ever close above 14,000, fell to an intraday low of 12,518 less than one month later.

Were we surprised by how events unfolded? Not really, as we had already held the opinion that fixed income investors were broadly underpricing credit risk. And that, we had thought, was an accident waiting to happen – one that we had witnessed in one form or another several times before. What we were surprised by was the rapidity with which the repricing occurred, and the quickness and severity with which the "crisis of confidence" spilled over into the general capital markets.

So What Now?

Uncertainty has risen. Because the sub-prime meltdown was concentrated in structured products and the capital markets, analyzing its effects on the general economy is somewhat akin to viewing an iceberg from the ocean's surface. It's very difficult to comprehend the scope. No one is quite sure which financial products are contaminated or who all of the holders are. We consider it likely, however, that any additional losses will be widely dispersed and of limited overall economic significance.

Even prior to the meltdown, U.S. economic growth was below trend. Clearly now, economic prospects have dimmed further. With the sub-prime debt meltdown and resulting credit squeeze, the velocity of money (the rate at which money cycles through the economy) slowed substantially. As a result, monetary policy, which had previously been comfortably expansionary, very quickly became too restrictive. Given that the current housing downturn appears likely to persist for at least several more months, an important consideration is the extent to which consumer spending will weaken further. Residential investment plus consumer spending accounts for some 75% of GDP. Another consideration is how much of an effect there will be on the global economy if the U.S. economy continues to weaken.

While the risk of recession has certainly increased, our opinion is that the most likely economic outcome will be two to three quarters of lackluster overall growth, but not an outright recession. The Federal Reserve Bank has plenty of ammunition at its disposal. And, as was recently demonstrated by its ½ point reduction in both the Federal Funds Target Rate and the Discount Rate, the Fed is ready and willing to take aggressive action to reflate the economy. Whatever inflation fears Federal Reserve Board members had previously felt seem to have been shelved by recent events. Financial panics are inherently deflationary. In fact, every financial panic, with the exception of the 1987 stock market crash, has led to lower rates of inflation.

We would also point to several other positive economic factors. To a large extent, the sub-prime mortgage meltdown is a domestic problem, whereas the global economy remains quite healthy and should continue on its favorable growth path. Global businesses,

including U.S. corporations, are underleveraged. For the most part, U.S. commercial banks are in good shape, as well. And while consumer spending may slow, it is unlikely to collapse, as long as the employment picture remains healthy.

Investment Summary and Outlook

From an investment standpoint, the current bull market in stocks is long in the tooth. We would not be surprised if further sub-prime debt uncertainty leads to another leg of stock market weakness. Yet, we find it hard to be bearish.

The current credit squeeze is disruptive but manageable. The Fed is reflating, and we have little reason to believe that it will not be successful in its efforts. The economy is likely to slow further, but we think that recession will be avoided for now. And even if a recession were to occur, we believe that it would be relatively mild and not present excessive downside risk to stock market investors.

Stock market valuations are quite reasonable, overall. Equities can even be considered undervalued, if one factors in the strong likelihood of a continued low-interest rate, low-inflation environment. The earnings growth outlook is favorable, as well. U.S. corporate productivity is high, the global economy is expanding, and well-managed, well-situated U.S. companies will benefit. The risk/reward trade-off is favorable, in our opinion.

That said, our current investment posture is somewhat defensive. We have chosen to retain some buying power so that we will be positioned to take advantage of any further stock market weakness. Also, our move toward large capitalization, higher quality stocks in recent months seems to be bearing fruit. Not only were these larger stocks relatively cheap, but they also tend to have greater exposure to the global economy, a situation we favor.

Stock market corrections and periodic bear markets are normal, healthy occurrences and serve positively to purge the market of excesses and restore value. Two or three times a century, bear markets turn secular and destructive, but one such period just ended in 2002 and we don’t expect another any time soon. Furthermore, secular declines tend to occur from much higher levels of valuation. The bottom line is that while we expect continued volatility over the coming months, we remain constructive on the U.S. equities markets.

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