



Second Quarter 2008 Review & Commentary

Overview

The volatility of the first quarter continued into the second quarter of 2008, but it was a considerable improvement over the prior quarter. A number of equity asset classes did well as did lower quality fixed income.

Equities (Stocks)

Domestically stocks were sharply divided in performance between growth and value, with growth stocks being the clear winner across all market caps. In the Large Caps, growth funds gained 1.6% while value funds lost 3.9%. Mid Cap growth funds gained 5% while Mid Cap value was even for the quarter. In the Small Cap growth gained 3.6% and the value funds lost 1.8%.

International funds had an average loss of 1.8% for the quarter. Emerging Market funds lost an average of just 1% for the quarter. Latin American funds provided a bright spot with a return of 10% for the quarter.

Natural Resources funds turned in stunning returns for the quarter with funds averaging 25%. Real Estate funds continued to suffer losing 5.1% for the quarter.

Fixed Income (Bonds)

Bonds left their recent obsession with quality behind. The average Intermediate Government bond fund lost 1.3% for the quarter. High Yield bond funds rebounded with an average gain of 1.5% for the quarter.

Indices cited above are as reported in The Wall Street Journal, both print and online, July 2, 2008. Fund averages cited are the respective Lipper Mutual Fund Indices.



Second Quarter 2008 Commentary

“Bankers have come up with these new ways to lose money when the old ways were working so well.”

John Stumpf

An inevitable part of the investment business is forecasting and prognosticating. As part of managing money, therefore, I spend an inordinate amount of my time reading and watching the views and predictions of others in order to discern the good from the bad and the valid from the ridiculous (sort of an intellectual separation of wheat from chaff). Normally these predictions tend not to vary a great deal as presumably no one wants to look too silly being separated from the herd if their prediction goes awry. This has certainly not been the case lately, however as predictions have ranged from “everything will be just fine” to “Armageddon.” Needless to say the latter tends to get much more press. This media malaise has led to what one observer termed “an emotional recession.” So, with that backdrop, let’s take a closer look at the current situation and see if we can’t sort this out for ourselves.

By my observation we are in the throws of four separate, but interrelated, crises at once; credit, residential real estate, derivatives and energy. So let’s look at each of these in order to try to understand the dynamics and interrelations a little better.

Credit

As has been discussed at length in previous commentaries, credit crises are certainly nothing new. This one, like past ones, took a long time to develop and involved a long-term shift from debt avoidance by those who remembered the Great Depression all too well to a great embrace of debt by those thinking it was different this time. Beginning in the 1980’s, accelerating into the 1990’s and culminating last year the US saw debt levels at the government, individual and institutional levels increase dramatically. The current account deficit (what money flows into the country minus what flows out of it) rose four fold from 1.5% of GDP in 1995 to 6% in 2006. Household debt went from around 93% of disposable income in 1997 to 133% of disposable income last year. This increase in debt was funded on the government side by the sales of bonds to foreigners and on the personal side by home equity loans. This increased home equity indebtedness required ever lower lending standards leading to the excess issuance of sub-prime mortgages.

Exacerbating the situation was the fact that much of this increased indebtedness was used for consumption of (a.k.a. blown on) goods that were produced overseas. This of course, increased the current account deficit and required the sales of more bonds to foreigners.

The taking on of excess leverage wasn’t confined to just individuals and government. Like the dealer that becomes a junkie because he thinks he’s immune to the stuff, the very Wall Street firms who aided and abetted the overleveraging binge had themselves fallen victim to it. At the end of last year Bear Stearns was leveraged 34 to 1. That is, for every dollar in equity they had \$34 in debt (the institutional equivalent of buying a house with 3% down). As you’re probably aware, this led to Bear Stearns going away.

Merrill Lynch wasn't far behind, having \$32 in leverage for every dollar in equity. So far, they have managed to avoid going down the path of Bear Stearns. However, they recently sold collateralized debt obligations with a face value of \$30.6 billion dollars for *22 cents on the dollar. That's a 78% loss in about a year.* This is their own money. To reuse our prior example, it is the equivalent of buying a house for 3% down and then a year later selling it for a quarter of what you paid for it. As you may have heard, Merrill Lynch fancies itself quite the manager of other people's money. I hope you feel much better about the performance of your own account.

James Grant, editor of the self-titled Grant's Interest Rate Observer recently wrote in a Wall Street Journal editorial that "*Leverage, as the laying-on of debt is known in the trade, is the Hamburger Helper of finance. It makes a little capital go a long way, often much farther than it safely should. Managing balance sheets as highly leveraged as Wall Street's requires a keen eye and superb judgment. The rub is that human beings err.*" They sure do. To err may be human, but apparently sometimes it can be pretty profitable too. In the case of now former Merrill Lynch CEO Stan O'Neill, erring got him \$160 million on the way out the door.

Simply said, whether you're a world, a nation, an institution or an individual, if you spend more than you make it will ultimately not end well, even if you do start with a lot of money.

While the above describes what happened, it doesn't tell us why. My belief is that ultimately the cause will be identified as lack of average wage growth. Numerous studies have shown that real wage growth for the overwhelming majority of workers has been flat for years. So maybe it wasn't all wild, profligate spending that lead to all of that debt.

Residential Real Estate

All of this easy financing caused demand for residential real estate to increase substantially and the price rose along with it. You can see here the self-reinforcing cycle of more valuable real estate leading to more leverage, in turn leading to more demand and more valuable real estate. Unfortunately for many the cycle has been self-reinforcing on the way down as credit has tightened.

The credit crisis will end as markets realize that the housing crisis has stopped getting worse. There are some helpful signs in that regard. The recent housing bill that among other things, reiterated the government's commitment to stand behind Fannie Mae and Freddie Mac (the nicknames for the two government-sponsored entities that back the majority of mortgages issued) likely marked the nadir of the credit crisis. Debt investors needed to know exactly how bad the worst case scenario could be and this, I believe, effectively answered that question. That said, a great deal more volatility could ensue should those guarantees actually have to be used.

This is certainly not to say all is going to be roses and sunshine in the housing or the credit markets. There are three phases to resolving residential housing. The first is

delinquency/default in which homeowners fall behind on payments or stop making them all together. This generally has to go on for six months or more before the actual foreclosure process can begin, which can take another three to six months. So we would expect to first see a slowing in the growth of defaults, then a decline in foreclosures along with a greater percentage of the properties that are sold being foreclosures. Recent data is beginning to indicate that is exactly what is happening.

The worst of the subprime mortgages now seem to have been issued in the first half of 2007 and the statistics regarding them are not pretty. 27.2% of subprime loans originated by Washington Mutual in 2007 were at least 30 days past due at the end of the second quarter. According to a study by Swiss bank UBS 65% of subprime loans originated in 2007 will end up in default.

A recent research paper published by the Mortgage Bankers Association, who presumably have quite an interest in this sort of thing, stated “... *that foreclosures drew buyers in Southern California. Home sales in the area surged 22 percent in April from March, with homes under \$500,000 accounting for two-thirds of the monthly gain. Nearly 38 percent of homes sold in April were in foreclosure at some point during the previous 12 months, compared with only 5 percent in April 2007. The area’s median home price was \$385,000, down 24 percent from \$505,000 in April 2007.*”

While 65% of 2007 subprime loans defaulting, a spike in foreclosures and a 24% drop in home prices may not seem like happy news but it is, in fact, encouraging. We know the 2007 vintage is as bad as loans get, so the ones issued in the second half of 2007 and later should start to show significantly lower default rates. Foreclosed properties actually being sold is an encouraging sign that there are buyers out there somewhere at some price and the market is beginning of the clearing process. So while the worst may not exactly be behind us, we can at least start to make it out in front of us.

Derivatives

As noted above, in order to lure investors into financing ever riskier mortgages, Wall Street had to convince the investors that they weren’t really riskier. This was accomplished through the magic of derivatives and was the inspiration for the quote at the beginning of this piece. By packaging the lower quality mortgages together and creating the resulting derivatives, investors came to believe that risk and return could be separated with the risk being neatly disposed of. This allowed lower quality mortgages to be funded while seemingly avoiding the risks that they represented.

I’ve written about issues with the derivatives markets for literally years now. While the issue hasn’t gone away and has, in fact, gotten larger there is beginning to be some evidence that regulators are uncharacteristically willing to address the situation before it becomes dire.

As noted in previous commentaries, of primary concern is the market for credit default swaps. These amount to insurance against loan defaults that are privately written between two parties, normally institutions or hedge funds. Like most markets, this one depends on confidence to operate properly. In this case the confidence that the other party will

actually pay when and if the time comes is critical. Add in the facts that many of the large banks that are party to these transactions are already having problems carrying these swaps on their balance sheets, and that the market has grown to a nearly \$500 trillion unregulated market place. Well, you can see the potential for hijinx. The largest potential problem is the lack of transparency in the market for these derivatives. Up until now, no one really knows what anyone else's exposure has been, since these transactions are conducted privately between two parties.

There is a light at the end of the tunnel here as well though. The New York Fed recently announced plans for the creation of an exchange and to provide some oversight and visibility to these contracts. It's somewhat heartening to see issues such as these that I was in the clear minority in ringing the alarm bells on (see first quarter 2006 commentary) finally get some attention.

Energy

What about the energy crisis? I've argued for a while that the current run-up in energy is more about speculation than supply and demand. I would further argue that this speculation has been undertaken mostly through derivatives and funded in large part by non-US sovereign wealth funds that have become bloated with all of those imbalanced trade dollars noted earlier. The rising price of oil has also been exacerbated by a significantly weaker dollar, which has also been a function of trade imbalances and our gorging on debt for the last few decades.

There is some good news though. It would appear that some basic laws of economics still apply after all and if the price of oil and gas get prohibitively expensive, the demand will decrease. The new buzz phrase in oil these days is "demand destruction." It would seem that we do love our SUVs, but not at any cost. At \$4.50 a gallon we seem to dislike them quite a bit.

As noted in prior commentaries, oil is short-term inelastic, long-term elastic. In other words we can't do much in the short run, except try to use as little as possible, but in the long run we can employ alternatives. At any price over about \$50 a barrel, just about every imaginable alternative source of power makes economic sense, right down to Gilligan's bicycle-and-coconut-powered generator.

While we have certainly been in a position before of beginning to adopt alternative energy sources as a result of expensive oil, only to abandon the effort when prices came down, I would hope that it's different this time. I say that because we have two motivating factors besides just the cost for finding alternatives to oil. The first is a considerably heightened sense of the environmental impact of oil usage. The second, and widely overlooked, motivational force is national security. It's unthinkable that a nation would put itself in the position of depending on what are often unfriendly countries for 75% of a critical resource, but that is exactly what we've done.

Resolution

So, we've made a case for the stabilization of energy costs, based on supply and demand. We can further strengthen the case for energy price stabilization with a strengthening of the dollar as a result of the news in the credit and residential real estate markets not getting worse.

This is important because for the last year or so, the bad news has routinely exceeded the overwhelming majority of expectations. In early November 2007, the Wall Street Journal posted a short piece on its website titled "\$500 Billion: The Mother of All Write-Down Estimates." It quoted an analyst who had the then radical idea that banks and brokerages around the world could have to write off as much as \$500 billion related to bad mortgage debts. At the time other estimates at the high end were \$100 billion. We are just around \$500 billion mark today with more write-offs likely to come before the dust settles and estimates of a cool \$1 trillion in write downs are being bandied about.

The debt and residential housing crises then would seem to be at least on the path of resolution and we mostly know what the journey along that path is going to look like. The energy crisis for its part is showing some encouraging developments with the oil bubble at least showing some cracks if not bursting.

The Pendulums Swing

Economists like to talk about systems being in equilibrium. In practice, however, equilibrium is fleeting at best. To expand this concept, the use of a pendulum as a model for capital market factors is useful. We can talk about where the pendulum is "on average" but, like economic equilibrium, a mere split second of the pendulum's cycle is actually spent there.

Imagine being seated on a giant pendulum and being unaware of the overall pattern of movement. Just at the exact moment of *change in direction* you would have the highest expectation of *continuing in the same direction* because of your length of experience in moving in that direction.

Physicists can tell us a couple of facts about the pendulum's movements. Through the center or "average" is when it has the greatest velocity (moves the fastest). When it's changing direction is when it has the greatest potential energy.

If one was on our previously mentioned giant pendulum and again completely unaware of the mechanics of the motion which they were subject to surely it would be a strange and likely terrifying experience. If, however, you were a physics buff (as so many of us are) and clearly understood the dynamics you were subject to, you would likely find the ride quite interesting and fascinating.

So I think we can effectively apply the pendulum thought experiment to broad policy, capital markets and investor behavior. We have gone from a long period of investors taking on increasing amounts of risk (even though in some cases they may not have been

fully aware of it) to what will probably be a long period of risk-aversion. We have also had an era of increasing deregulation which is likely on the cusp of seeing a shift away from the laissez faire policies that have increasingly dominated the last 25 years and arguably have resulted in the myriad bad deeds undertaken by Wall Street and the lack of wage growth. Oil prices will reverse at the moment of lowest expectation rather than go to infinity. Value buyers will come into the market and reverse the decline rather than the value of every home in America going to zero. Stocks will rebound at the moment of lowest expectation. So the pendulums swing.

Stocks

One market that is decidedly not having a crisis, but is sharing in the malaise induced by the other crises is the equity market. You're probably all too well aware that stocks have had a difficult period. Those that pick individual stocks continued to be brutally punished for wrong picks. GM shareholders, for example saw the value of their holdings decline by 40% for the quarter and roughly 75% since last October. Not the near total wipe out of Bear Stearns shareholders, but painful nonetheless. The stock's current price is at its lowest going back to at least 1960 and it sports a dividend yield of almost 10%. There are similar tales of woe for a number of companies, especially in the banking and retail sectors. Citigroup and Merrill Lynch have also both lost the better part of 75% of their value since last October.

Internationally, China, which was all the rage has lost nearly half of its value in less than a year as represented by the S&P China ETF. It was also very fashionable earlier in the year to be in "BRICs" or the stocks of Brazil, Russia, India and China. This strategy has relieved investors of roughly 25% of their capital since May.

The point of all of this is not to induce panic and trigger a flight to capital to coffee cans buried in backyards across America. Rather, it should illustrate the tremendous opportunities being created.

Much of the financial media has written of the current P/E ratio of the S&P 500 being around 20, which is somewhat expensive relative to the long term average of 15. Few, however seem to have taken the time to dig deeper into the statistic. While it's true that the overall P/E of the S&P 500 is 19.3 times operating earnings, a closer look reveals that financial stocks make up just under 15% of the index. The financial stocks also have a P/E of 45 due to all of the recent massive write-down's mentioned earlier, which substantially increases the P/E for the entire index. By my calculation, if one takes the financials out of the index, we are left with a P/E of 15.09 or just about the long term average. The same scenario largely holds for domestic Mid and Small Cap stocks as well.

Conclusion

This is not to say things will be all smooth sailing in the least. The common theme through these many pages is that while the last few quarters may have been unpleasant, and there may well be more unpleasantness to come, there are silver linings to all of these clouds. Bubbles always go higher and further and crashes go deeper and last longer than

anyone ever thinks possible. We certainly will see more credit market turmoil, quite likely including the failure of one or more large institutions, a number of smaller ones and an actual government bailout of Fannie Mae and Freddie Mac. But expectations have certainly been adjusted to include these possibilities, and they are probably included in securities prices. It is also important to realize that stock prices are an anticipatory mechanism. That is to say equity markets are forward looking and they price in what is going to happen, probably with a three to six month outlook.

Ultimately periods of great opportunity follow periods of great trouble. To quote Mason Hawkins and Staley Cates, managers of the Longleaf funds, “historically the best time to invest has been when owning stocks feels the worst.” Put more bluntly by the recently departed Sir John Templeton, “buy when there’s blood in the streets.” As a buying opportunity we will quite likely look back on these as the good old days.

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