

Investment Outlook & Commentary Fourth Quarter, 2008

The world holds its breath as the new Leader of the Free World, Secretary of Treasury Henry Paulson, mobilizes an uncharacteristically bipartisan Congress to rescue the world from systemic financial collapse.

A crisis that started with the fall of subprime mortgage issuers and then Bear Stearns has spread to small and large firms alike. FDIC has seized over a dozen banks; Lehman Brothers and Washington Mutual have declared bankruptcy; and the government has bailed out AIG and taken over Fannie Mae and Freddie Mac. Credit markets have seized, and loans are scarce even among the creditworthy. A flight to quality has driven Treasury yields to historic lows.

Mr. Paulson is leading an effort to purchase \$700 billion of embattled, even toxic, assets among the nation's banks, insurers, and investment houses. After failing to pass the House of Representatives last week in Mr. Paulson's simple, three page form, H.R. 1424 has grown to 451 pages with legislative add-ons. The U.S. government and its taxpayers are entering a new era, an expansion of size and powers rivaling perhaps that of the FDR's New Deal. The U.S. government will run the world's largest investment fund.

Surely, the bailout has drawn fierce debate. We have strong feelings on the matter but also realize the profound severity and complexity of both the problem and proposed solution are nothing short of intellectually humbling. We will be wrapping our collective heads around this for some time to come.

A levered world

Amid this mess, we think it's useful to review how we got here.

The heart of this crisis has been, and will continue to be, the massive amounts of leverage accumulated in our financial system, mostly since 2002. Fueled by low and steady interest rates, banks, Wall Street houses, and insurers accumulated huge leverage to grab higher yielding securities, particularly mortgage-related obligations, amid a historic bull-run in real estate.

The ensuing virtuous cycle invited massive risk taking. Fannie Mae and Freddie Mac, two private companies enjoying an implied government backstop among investors, levered 40-to-1—that is, borrowed at virtually Treasury rates \$40 for every \$1 of capital held—to buy not just modest mortgages from creditworthy borrowers, but also (with Washington's support) lower quality and subprime mortgages from mortgage brokers and Wall Street. Fannie and Freddie grew to account for half of the nation's \$12 trillion mortgage market.

With riskier higher yielding mortgage securities legitimized in the minds of financial institutions and investors alike, a feeding frenzy ensued. Aiding the bubble were insurers and other firms eager to insure the credit of mortgage securities (even subprime ones) via credit default swaps (CDSs). AIG, the world's largest insurer, amassed some \$440 billion in CDS exposure that contributed to its downfall. Other participants, including MBIA and Ambac, the nation's largest insurers of municipal bonds, also entered the CDS game. Today, the size of the CDS market is roughly \$62 trillion.

The Great Unwinding

Leverage works when asset prices escalate, and indeed huge fortunes were made. What we are seeing now is how perilous leverage can also be, what happens when a homeowner, who after electing for 100% financing, sees his home's value drop below what he owes on it; what happens when firms like Lehman Brothers and Fannie Mae crumble under dubious assets levered 30-to-1 and 40-to-1; what happens when insurers discover they've completely miscalculated the risk of insuring now-toxic assets held seemingly everywhere; what happens when banks squander their depositors' trust by emulating Wall Street's excesses.

No, we can't sugar-coat the Great Unwinding. It's here, it's nasty, and it will likely take time and many victims—both deserved ones and bystanders—before it gets better.

And if that weren't enough, the probability of higher tax rates grows, and the U.S. and worldwide economies are slipping quietly into recession, resulting in lower corporate profits, the mother's milk of equity investing.

Although we've pared down equity exposure and are holding ample amounts of Treasuries and cash, you may wonder, "Given the grim outlook, why have *any* exposure to stocks?" It's a fair question.

Going Forward

While risk continues to elevate, and our confidence is shaken in the political and market players who make our system, we are not without faith that holding a good, but not dangerous, allocation in some of the world's best businesses makes for sound investing over time.

The companies we typically look for—those with relatively stable products, strong earnings generation, and little need for debt to operate or grow—are worthwhile investments, even in negative markets. In fact, in times like these, when fear and volatility drop the values of all stocks, we should be looking for great businesses at sale-like prices.

We find it constructive (and a bit amusing) to think as if we were Saudi princes, awash in hundreds of billions of petrol-dollars and needing good investments for our wealth. Would we slice and dice our money between various strategies and products and across thousands of stocks? We could invest like Noah (two of everything), but we would rather grab the entire stock of the world's greatest brands and operators, knowing that over time, our investment would grow and compound nicely.

Believing that *we would buy* these entire companies had we the money, we feel much better about putting a smaller portion of our *clients' money* in these companies today. It feels even better knowing we have ample cash set aside to buy some more—we hope we can do so in moments of extreme market pessimism and at depressed prices.

At least this is the game plan, and something that we may have to remind ourselves over and over again as we watch this saga unfold.
