<u>QUARTERLY REPORT</u>

Fourth Quarter 2007

RISK AND REWARD ON STEROIDS IN 2008

Investors today may be faced with the most difficult and meaningful decisions of their investment lifetimes. The amount of leverage that has been built into the world economy has raised financial stakes as never before. In a matter of just months the largest financial firms in the world have recognized investment losses that amount to major portions of their net worth. These failed investments have led to the collapse of hedge funds and of a major bond insurance firm, while threatening the effective function of the entire credit market. Recognizing the seriousness of the crisis, the central banks of the world are throwing massive amounts of money at the problem. Whether they succeed or fail at righting the ship could lead to dramatic market moves either up or down.

Mea Culpa

Every week the line gets longer. Major banks, investment banks and brokers continue to march to the confessional to admit that they have lost hundreds of millions to tens of billions of dollars. So far over $100 billion has been written off in the aggregate, but the estimates of the scope of the problem range from $250 to $500 billion in the subprime arena alone. If such estimates are even close to being accurate, much more corporate financial pain lies ahead.

While not all have yet stepped up to admit their investment malfeasance, the list already includes most of the high and mighty in the world of finance: Citigroup, Merrill Lynch, Bank of America, Deutsche Bank, UBS, Goldman Sachs, JP Morgan Chase, Wachovia, Morgan Stanley, Lehman, Bear Stearns, Credit Suisse, Legg Mason, Janus, US Bancorp, SunTrust and HSBC. And the list goes on. What were they thinking?

Apparently, these giants and many far lesser lights suspended belief in the basic financial principle that there's no such thing as a free lunch. Why would they believe that they could buy a security bearing a AAA credit rating with a yield far above other AAA securities? No bond issuer is going to provide that extra yield out of the goodness of his heart. That the market demands a higher yield to get the issue placed is prima facie evidence that this is a less worthy credit. By extension, this episode has to cast doubt on the true financial sophistication and the quality of advice offered by those who fell victim to this financial disaster. As we have learned from the necessity of massive capital infusions, some of the allegedly "best and brightest" firms risked and lost large percentages of their underlying capital.

How Safe Is Your Money Market Fund?

While the mighty falling always catches people's attention, do these stories have relevance at the investor level? Reports over the past two months demonstrate that they certainly do. Both individual and institutional investors have rested secure for years in the belief that any funds put in money market funds would ultimately come back with interest earned. Regulators demanded that such funds invest only in the best quality securities. On the off-chance that any such security declined appreciably in price, the fund's management company almost invariably ponied up the necessary capital to prevent the fund from "breaking the buck" or falling beneath $1 per share.

In their quest for higher yields, a great many money market funds succumbed to the temptations of high yielding mortgage-backed securities with ratings that proved to be overstated. So far the money management firms or their bank holding companies have rescued their investors from loss, and that remains likely unless the credit crisis unravels to a greater degree. (See the enclosed article from *USA Today*.)

For decades we have urged investors to take effectively no risk in their short-term cash management programs. Incremental returns are simply not great enough to justify any appreciable risk of principal. Toward that end, we invest the bulk of our short-term cash in U.S. Government guaranteed securities with nothing riskier than four- or five-week loans to such A_1/P_1 rated entities as the finance arms of General Electric, American Express and Chevron Texaco. Our preliminary return on such short-term funds in 2007 was 5.32%, far better than almost all competing cash equivalent alternatives, most of which took far greater risks with investors' funds. We would be pleased to discuss a tailored short-term cash management program for institutions or individuals with $1 million or more in short-term funds.

Central Banks To The Rescue

These adventures in mismanagement throughout the financial system have prodded the U.S. Federal Reserve and the central banks of the world into frenzied action. After failing to perceive the danger of the housing bubble and the subprime mortgage situation as it developed in recent years, the central banks are attacking the resultant credit crisis full bore. The open question is whether a crisis born of excess liquidity can be solved by the infusion of more liquidity. At the very least, the scope of the current and proposed rescue efforts, by far the largest in world history, argues that the monetary authorities certainly recognize this as a crisis. Now we have to hope that they can solve it.

The New Shadow Banking System

There is substantial evidence to create doubts about the Fed's potential for success in the current crisis. Fundamental to that concern is the evolution from the traditional banking system to today's "shadow banking system." Bill Gross, managing director of PIMCO, which actively manages more bonds than any other non-governmental entity, recently pointed out some similarities and differences. He warned that "… modern finance is centered around banking and now, unfortunately, around shadow banking. Both … are built on a fundamental … mismatch:

they borrow short and lend longer and riskier. Recognizing this flaw, governments have for over a century mandated that banks have an ample percentage of reserves in order to bridge the liquidity and investment risks that periodically ensue … ."

"But today's banking system … has morphed into something entirely different and inherently more risky. Our modern shadow banking system craftily dodges the reserve requirements of traditional institutions and promotes a chain letter, pyramid scheme of leverage, based in many cases on <u>no</u> reserve cushion whatsoever. Financial derivatives of all descriptions are involved but credit default swaps (CDS) [insurance against bond defaults] are perhaps the most egregious offenders … . [T]he conduits that hold CDS contracts are in effect non-regulated banks, much like their hedge fund brethren, with no requirements to hold reserves … ."

Explosion In Debt And Derivatives

A banking system without reserves is a scary concept, but not terribly dangerous if it's limited in size. Unfortunately, that's not the case in today's world. The Bank for International Settlements reported that $43 trillion in credit default swaps were outstanding at the end of 2007, more than half the size of the entire asset base of the global banking system. Total derivatives are ten or more times the value of all the world's stock markets and more than three times the value of all the world's stock and bond markets combined.

Those who have read our reports or attended our conferences over the years know that we have warned repeatedly about the explosion in derivatives and leverage in general. We have frequently reminded our audiences of Warren Buffett's characterization of derivatives as "financial weapons of mass destruction." Ominously, the investment world could suffer mightily from ignoring the Oracle of Omaha's counsel.

Where Were The Regulators?

Readers and conference attendees also know that I have never been a fan of Alan Greenspan, despite the almost iconic status accorded the former Fed chief. Once markets turn down, penalized investors always look for scapegoats, and Alan currently presents himself as a fat target. My primary objection has been that Greenspan never saw a problem he couldn't inflate away, with the consequences to be borne by subsequent generations. He facilitated the stock market bubble; he directly promoted the real estate bubble; and he allowed the monumental credit bubble to inflate under his watch. Culpability is not his alone, but he had more power than anyone else to minimize each of these problems. Now the world may be faced with picking up the pieces.

The lack of any reasonable regulatory oversight has allowed aggressive hedge fund operators and others to magnify risk/reward potential virtually at will. A close friend, highly successful in real estate, recently asked me somewhat incredulously how these subprime securities could so rapidly become worthless. After all, the underlying property isn't worthless. Again, the culprit is largely unregulated leverage. A security with just five-to-one leverage -- and many are far more aggressive-- becomes worthless with a 20% decline in property value.

Problems Compounding

As if the subprime problem were not sufficient, ripples from this crash are spreading across the financial pond. The viability of bond insurance firms is now being called into question. Firms like Ambac, MBIA and ACA, which offer guarantees to back the bonds of cities and local municipal entities, have their own capital endangered. The rating agencies have already downgraded ACA to junk status, effectively knocking it out of business. In turn, Merrill Lynch reduced the value of a portfolio by over $3 billion because of investments connected to ACA. Ambac and MBIA together insure $700 billion in municipal bonds. Ratings downgrades of these firms could result in downgrades to the bonds they insure. Values of those bonds would immediately decline, and future borrowing costs would rise.

Once again, those who have followed our recommendations know that we have long counseled investors to rely only on the credit worthiness of the underlying entity, never the bond insurer. A separate but similar piece of advice is not to put any more money with a single annuity sponsor than you would invest in that company's bonds. Guarantors can fail.

The problems in residential real estate are well known, and opinions on how deep the crisis will descend or how long it will last range across a wide spectrum. Now, however, we're starting to see cracks in the formerly strong commercial real estate facade. Reports from New York profile one major owner putting a large office building up for sale because its lender requires more equity to offset heavy leverage on a multi-building portfolio. It's hardly a stretch to imagine lenders throughout the country reducing their debt-to-equity ratios, which could result in much more property being put up for sale in a potentially weakening market.

There are other credit-related woes surfacing. Large increases in delinquencies in credit card loans, auto loans and student loans have been recorded in the final quarter of 2007. As was the case with mortgage loans, Wall Street found a way to make money by securitizing, packaging and marketing such loans. I have found little data on the scope of that securitization, but it is highly likely that financial engineers geared up the leverage of such loans as they did with mortgages. If the delinquency rates continue to rise in these areas, more credit problems are likely.

Recession Potential Grows

Existing credit problems will almost certainly lead to a cutback in credit availability. Goldman Sachs economist Jan Hatzius estimates that $200-$400 billion of mortgage-related losses may lead to a $2 trillion reduction in aggregate lending. Accepting that figure, Bill Gross suggests adding an estimated $250 billion loss from CDS plus prospective losses in commercial real estate and credit cards in 2008. He sees the resulting credit contraction leading to a recession.

As each day passes, fresh data point to the increasing likelihood of a recession, either in progress or in prospect. Unemployment always increases in a recession, and in a society burdened by the greatest debt burdens in history, unemployment would almost certainly raise default levels in all debt categories. Americans have very little liquid saving to fall back on.

Can The Fed Succeed? Lenders May Call The Tune

While the Fed may have been remiss in permitting the problems to escalate to present levels, they are now fully conscious of what they face. Fed Chairman Ben Bernanke has committed as much Fed action as is necessary to counteract the credit crisis and business slowdown while attempting to maintain price stability. As indicated earlier, it's an open question as to whether they can succeed. The consequences to investors are monumental.

In a debt-laden economy, failing credit markets are deflationary. This country has not experienced a debt deflation since the depression of the 1930's. The Federal Reserve has indicated clearly that they will provide whatever liquidity is needed to counter such an outcome. The danger, of course, on the other side is that a flood of new money will result in a huge jump in inflation. Recognizing deflation as by far the more dangerous of the alternatives, the Fed will try to solve the credit crisis and possible recession first and worry about inflation later.

Normally the securities markets and the economy respond favorably to aggressive Fed easing. The question in this cycle is whether liquidity added to the banking system will cycle its way through the economy. In a crisis, borrowers in need want to borrow, but already burned lenders may be reluctant to lend. The success of the Fed's efforts will depend upon the confidence level of lenders. Most lenders have already tightened lending standards. If defaults continue in any of the several areas discussed earlier, it is not clear what will make lenders more eager to lend except at prohibitively high rates.

Consequences For The Investor

If the Fed succeeds, it will almost certainly be the result of a dramatic reflation of the banking system. We can expect that another bubble will be blown with the next round of easy money, although the likely subject of such a bubble is not immediately evident. In such an environment, in a levered environment like ours, securities prices could again soar.

If the Fed fails, debt defaults could cycle through the economy and the markets, and investors would likely face a severe continuation of the bear market that began in 2000. The aftermath could last for years.

Investors have no clear guides. It's always dangerous to forecast an epochal change of economic or market conditions. On the other hand, the current worldwide credit crisis is the worst in modern history, magnified by derivatives and unprecedented levels of leverage. If the Fed cannot rebuild business and investor confidence, it is impossible to predict the extent of the fallout.

Each investor, institutional or individual, must determine what level of risk to accept in an environment in which the potential outcomes and consequences are so diametrically diverse. We lean to the cautious side.

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Subprime loan woes

Money market funds at risk?

Bank of America plans a $600 million cushion

By John Waggoner
USA TODAY

Bank of America, stung by the fallout in subprime mortgages, acted Tuesday to safeguard a bedrock investment of ordinary Americans: money market mutual funds.

The bank said it planned to set aside $600 million to cover potential losses in its money market funds and an institutional cash management fund.

The action by the second-largest U.S. bank is the largest recent step by a financial institution to ensure that its money funds don't have to reduce the value of their shares. Money funds have long appealed to people as super-safe investments and have kept their value at $1 a share. But unlike banks' money market deposit accounts, money funds aren't federally insured.

The crisis in subprime mortgages has jolted the market for the short-term securities that money funds invest in. Even so, assets in money funds recently hit a record $3 trillion.

Bank of America's move is a sign the crisis has could potentially affect everyday savers.

The bank said in a filing with the Securities and Exchange Commission that $300 million will be used by a group of its money funds that are offered to individuals. The other $300 million will support an institutional cash fund, not technically a money fund. The money would help keep the funds' share price at $1 if some of their holdings defaulted.

Several other financial institutions have also bolstered their money funds:

- SEI, an institutional money manager based in Oaks, Pa., has set aside $129 million to support two of its money funds.
- Legg Mason, a Baltimore money management firm, has set up a $238 million line of credit for two money funds. It also invested $100 million to buoy an offshore money fund.
- SunTrust has received SEC permission to set up credit lines for two money funds.

What's tripped up many funds are investments in structured investment vehicles, or SIVs. SIVs use short-term loans to buy longer-term assets, such as mortgage-backed securities, that pay higher rates. The SIVs with the worst problems were often invested in subprime mortgages — home loans made to borrowers with risky credit. As housing prices have fallen, many more subprime borrowers have defaulted than Wall Street had expected. As a result, some SIVs have stuck money funds with losses.

Money funds fear that if any fund "broke the buck" falling below $1 a share, investors would flee. That's why they're moving fast to try to avoid defaults.

"What we're seeing is investment managers taking steps to make sure those who invest get their money," says Peter Rizzo, director of Standard & Poor's fund ratings group.

"Is a fund going to break a buck? I think the answer is no," says Peter Crane of *Money Fund Intelligence*.

Bank of America also said it expects to write down $3 billion of its debt and said the losses could worsen.

How money funds work

Money market funds invest in short-term liquid securities, such as Treasury bills. Unlike other mutual funds, money funds keep their share prices at $1, so shareholders won't lose money from daily fluctuations in the value of the funds' holdings. One small bank's institutional money fund saw its share price "break the buck" in 1994. It's the only money fund to have seen its net asset value fall below $1.