MARKET LETTER

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THIRD QUARTER 2008
Hubris

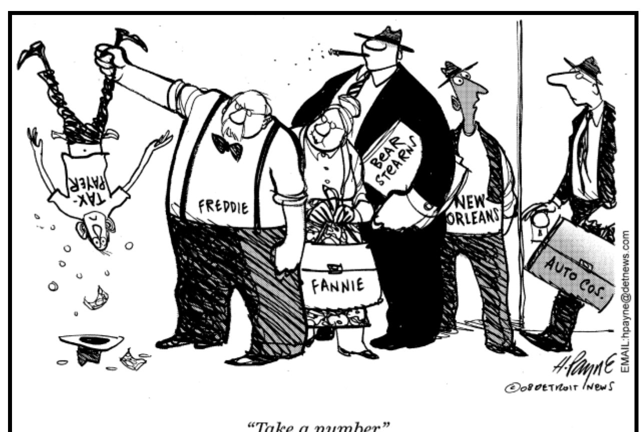
Principal Dean Dordevic offers a comparative analysis of recent and past national economic crises, finding some familiarity in the current turmoil.

hubris: hu.bris, n. excessive pride or self-confidence; arrogance. syn. over boldness, imprudence. ant. discretion, humility.

"Even Isaac Newton, of gravity fame but who also held the position of master of the mint, lost money in the South Sea Bubble. He got out, thinking it was a bubble, then got back in when it kept going up. He lost a small fortune in the process when it finally collapsed. Human greed, coupled with hubris, hasn't changed in the four centuries for which we have some sense of economic history."[1]

The financial markets are convulsing as tectonic shifts shake the financial system to its core. Bear Stearns, Fannie and Freddie, now AIG and 158-year-old Lehman Brothers are either gone or under some form of stewardship. Even 94-year-old Merrill Lynch sought the safe harbor of Bank of America. Both Goldman Sachs and Morgan Stanley have filed to become bank holding companies. Will the last person to leave Wall Street please turn out the lights?

We've been grinding through this problem for more than a year. Some have called this a crisis in slow motion; there is more than a grain of truth in that. We'll make the assumption that you understand (more or less) how we got here. As Todd G. Buchholz of *The Wall Street Journal* put it so succinctly, "*the real problem running throughout the system was not a lack of new regulations. It was a lack of skin – that is, skin in the game. Mortgage brokers turned into fly-by-nighters, immune from the effects of reckless decisions. Local bankers securitized loans and packed them off to some naïve investor or to a rating agency manned by analysts who weren't sharp enough to get a job at Bear Stearns or Lehman. Homebuyers who put nothing down or lied about their income could pack up and run off, leaving no skin behind.*"[2] True, but there's more to what's happening than that.



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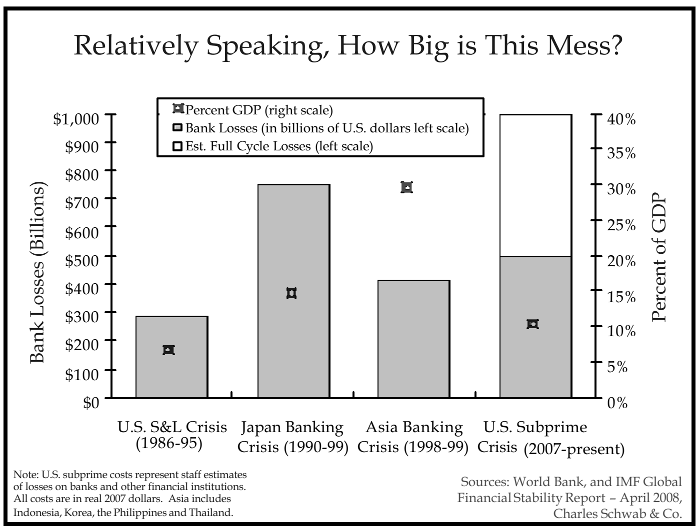
What we're witnessing is the end of a multi-decade period of hubris: the end of an era where risk was packaged and sold, but untested and poorly understood. This leverage (and risk) is being wrung from the system, albeit in an awkward and painful manner. When this de-leveraging process will run its course is impossible to predict. While the circumstances and the catalysts may have been different, we have been through crises and panics before, and hopefully history can help us quantify, and more fully understand, both the scope and impact of today's problem.

While this crisis might *feel* worse than others, we can gain some valuable insights by stepping back and looking at this crisis versus others. The best way to gauge the severity of this crisis is *relative to the size of our economy* (gross domestic product, or GDP). In very round numbers, we've thus far experienced some $500 billion in bank losses—quite obviously a moving target at the moment, but a reasonable estimate of the pain we've endured. It's been estimated that when all of this washes through the system, we'll experience losses of roughly double that figure. If this crisis unfolds that way, total losses would equate to about 8 percent of GDP.

To put this potential loss into perspective, it's best to calibrate that metric against the three most recent national or international financial crises. The U.S. Savings and Loan crisis (1986-1995) saw $300 billion in losses, or 8 percent of GDP. The banking crisis in Japan (1990-1999) resulted in about $750 billion in losses, or about 14 percent of their GDP. Finally, and most recently, the Asian banking crisis (1998-1999) booked $400 billion in losses, or about 28 percent of GDP of the impacted countries.

However, this crisis is a bit different than its predecessors in several important ways. It has involved more disparate entities; that is, it has impacted banks, insurers, investment banks, S&Ls, and it has been truly global in scope. It is also important to realize that there is a far greater volume of financial "esoterica" involved: opaque and often illiquid financial instruments that are exceedingly complex in nature. These instruments are difficult to understand and value, especially during periods of great uncertainty and stress in the financial system. To be sure, this has greatly compounded the problems the system currently faces.



What we learn from this exercise is that should this crisis result in losses of roughly double what we've experienced to date (one trillion dollars), relative to GDP (which we believe is the most appropriate benchmark), this crisis would be about as great as the S&L crisis that we experienced in the U.S. from 1986 to 1995. When everything is said and done, the cumulative losses could very well exceed one trillion dollars, but at a minimum this analysis gives us a historical point of reference. While no two events are exactly the same, we have experienced crises of a similar order of magnitude relative to the size of our economy, yet ultimately the financial system not only recovered, it grew stronger.

Going forward, the pain of de-leveraging will be felt broadly, but there will be some clear winners and losers. Generally speaking, the biggest losers will be those entities that are debt laden. Trying to sell assets into a market that, for those assets, is in decline is very difficult to do. The winners, of course, will be those that are deep-pocketed and are able to acquire these assets at bargain prices. This is something of a paradox at the moment, since there are many deep pockets around the globe that are flush with cash: sovereign wealth funds; corporate cash; individuals with cash; private equity, etc. What we currently lack is the confidence (the so-called Keynesian "animal spirits") of these entities to begin committing their resources, but in the end many will profit from this debacle.

As far as specific economic sectors and industries are concerned, undoubtedly more jobs will be lost and connecting the dots is fairly easy. Construction, anything related to real estate, finance, and autos will all continue to shrink. On the other hand, there are segments of the economy that are doing quite well. The energy complex and most export-oriented industries and companies are healthy. The economy looks like a barbell at the moment, with some sectors doing relatively well and others in recession or worse. The fact that the U.S. economy (GDP) grew 3.3 percent in the second quarter is quite remarkable. However, such data masks the relative "haves" and "have nots" beneath the number.

We have been gearing our portfolios for a slowing economy for some time now. It is our belief that growth will be slow well into next year. Therefore, we have emphasized the least cyclical and more defensive sectors and industries. We have also redoubled our focus on financial strength, cash flow and dividends. As a result, our core model portfolios have declined less than the overall market during this year.

It is very likely that a new period of financial market regulation will emerge from this debacle. What we need is a more appropriate and impactful set of regulations and regulators. The historical pattern, of course, is that the regulations that come from "on high" deal beautifully with yesterday's problem, often a day late and a dollar short. The good news is that when the dust settles, the markets have proven to be good at figuring this out. What we can say with confidence is that it will be a very, very long while before the risks that were resident in the system pre-crisis reappear. The saying "once bitten, twice shy" was never more appropriate.

As of this writing, Congress is working on a massive $700 billion "bailout proposal." The devil will be in the details, but a bailout will certainly help lubricate frozen financial markets. Going forward, there are many relatively simple changes that would have a positive impact. For example, modifying the so-called "mark-to-market" rules would have a huge influence. Changing the rules from the last sale to the average of the past six months would be a great compromise. If we've learned nothing more over the last few weeks, markets can be very emotional and inefficient in the short run, especially when illiquid, opaque assets are involved. Requiring more transparency for illiquid assets, creating standards for derivatives, curbing so-called "naked" short-selling and restoring the uptick rule for short selling would all help greatly.

The end of this great period of hubris will provide the seeds for a financial system that will be nothing like what preceded it. The biggest change at the margin will involve a dramatic recalibration of risk in the system. Conservative, "old school" lending will be very much in vogue, as will anachronisms such as clean balance sheets, cash, and dividends. This is good news, and it plays directly into our hand. The bad news is that credit will be less plentiful and more expensive. Surely, this is a prescription for slow economic growth, and we've rigged our sails for that kind of weather.

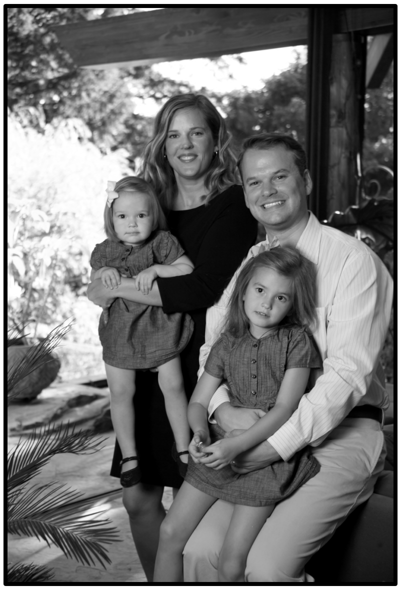
It is important during times like these to have a sense of both perspective *and* history. Analyst and market historian Ned Davis recently said it best: *"The stock market survived the Great Crash in 1929, then the Great Depression and severe deflation. It overcame WWII in the 1940s. It outlasted the assassination of JFK, the war in Vietnam, severe inflation, and it even survived the presidencies of Johnson, Nixon, and Carter. It revived after the 1987 crash, the S&L crises in 1990, and the invasion of Kuwait. It even survived 9/11, the popping of the 'Bubble of 2000,' and it will also survive the bursting of the housing bubble in 2007."*[3]

We think so, too.

Sources:
[1] Lawrence B. Lindsey, "The Panic of 2008." *The Wall Street Journal*, September 17, 2008.
[2] Todd G. Buchholz, "The Woe on Wall Street." *The Wall Street Journal*, September 19, 2008.
[3] Ned Davis, "How Do I Know There Is Light At The End of the Tunnel?" *Ned Davis Research – Institutional Hotline*, September 22, 2008.

Professional Profile:
Nathan Ayotte

Nathan Ayotte had good reason to be happy this summer; he joined Ferguson Wellman as a vice president and portfolio manager in July, enabling him to return to Portland, his hometown.



From left to right: Katherine, Elizabeth, Nathan, and Nathalie
Photography by Bruce Beaton

Ayotte most recently served as the branch manager of Scottrade's Park Avenue branch in Manhattan, which he helped open. "It was a wonderful opportunity," he says, "to help establish the presence of a fast-growing firm in its largest market; to manage a talented staff of brokers; to work with influential clients; and to be part of the face of Scottrade in New York City."

While he loves New York and still has many relatives there—his wife, Ella, is a Big Apple native—Ayotte says the move back to Portland is a great fit for his family. "It's a quality of life choice," he says.

Prior to joining Scottrade, Ayotte was an equity trader at Bidwell & Company in Portland. There h e managed a trading desk on behalf of investment managers and clients. What he learned there he notes, cannot be measured in mere market data, stock sales or block trades. "The best part of the job," says Ayotte," was working as closely as I did with Jerry Bidwell. Having daily interactions with such an important member of the Portland investment community was a terrific learning experience."

Nathan Ayotte holds a B.S. in psychology from the University of Oregon, with a minor in business administration. He is a member of the Stamford CFA Society in Connecticut and is a licensed FINRA Series 55 Equity Trader, Series 24 Securities Principal, and Series 4 Options Principal.

As Ferguson Wellman's newest portfolio manager, Ayotte is meeting with individual and institutional clients, getting up to speed on the firm's systems and processes, and reestablishing himself in the local investment community. On a typical day he begins work early, studying the latest market reports, meeting with colleagues, and working with other portfolio managers. "We're growing," says Chief Operating Officer Steve Holwerda, "and bringing Nathan on board allows us to keep providing the consistent high level of responsiveness our clients expect from us."

For his part, Ayotte feels he has landed in the catbird seat. "This is such an amazing company," he says. "A lot of places talk about camaraderie. Ferguson Wellman is unique because there's this great group of people who work so well together—and at the same time, each of us has our own unique approach to the market. You're able to make individual contributions and also to be part of something that's bigger than you alone."

He also places high stock (no pun intended) on the firm's community involvement. "The people here really walk the talk," says Ayotte. "I'm looking forward to getting involved locally so I can carry on our tradition of actively giving back."

Landing back in Portland allows Ayotte to preserve other traditions as well. His daughter Nathalie, who's five, now attends kindergarten at Ainsworth Elementary—where Nathan himself went. Katherine, at 19 months, plans to do a bit more preparation before she follows in her sister's footsteps. The family makes its home in the same Southwest Hills neighborhood where Nathan grew up. They enjoy visiting with Nathan's father, an architect, and stepmother, active in the Portland Garden Club. They also spend time with his mother and stepfather in Sheridan, where they manage a wildlife foundation. On weekends the Ayottes often stay at their family retreat in Sunriver, enjoying the sunny weather and high desert climate.