MARKET LETTER

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Crisis in Perspective

Marc Fovinci, CFA, principal and member of the fixed income team, takes a step back from the daily headlines and gives a broad perspective on the cascading effect of the subprime loans on the financial system and the economy.

Crisis and its Causes
- Over-investment
- Excessive lending leading to a liquidity crisis
- Financial market correction
- Economic decline

Do the bullet points listed above accurately describe today's environment? Yes, and they also describe almost every financial crisis in recorded history: from Dutch tulip bulbs in 1637 to the American Panic of 1837, up to and including the bursting of the technology stock bubble in 2000. Although modern economics and the Federal Reserve have moderated the extremes, the business cycle remains alive and well today.

Good economic times breed optimism and rising values of investable assets get extrapolated forward into infinity. Think of how an investor makes decisions at different stages of the economic cycle. When the economy is growing tentatively, an investor wants enough cash flow from the investment to pay interest and payback the principal of the investment. As the economy gets on firm footing and the chance of price declines diminishes, an investor does not worry about repayment of principal nearly as much, and looks for only enough cash flow to pay interest.

When the economy is hot, an investor does not even worry about interest, because he believes that the price will always be higher. This thinking can eventually become the realm of the "bigger fool theory," where an investor buys something at a ridiculously high price based upon the belief that there is a bigger fool out there to sell it to at an even higher price. Eventually, the last buyer buys, prices drop, and a financial crisis ensues. In 2000, the crisis was in technology stocks. In 2007 and 2008, it's residential housing. The subprime lending market appears to have been created to finance "bigger fools," servicing people with little income who could only afford a house if its value went up immediately.

The "bigger fools" create a financial "bubble." Interestingly, the term "bubble" was coined by the British back in 1720 to describe their "South Sea Bubble" financial crisis, a stock market craze where any idea seemed to merit investment. Like a soap bubble, a financial bubble keeps expanding until it pops and disappears. After a bubble pops, investors become pessimistic, risk-adverse and have a reluctance to invest. A "liquidity crisis" is then in effect, where money ceases to flow freely.

What is Liquidity?
"Liquidity" can be confusing because it is has three different meanings in the financial world. First, the Federal Reserve is said to "inject liquidity into the system" when it lowers the Federal funds rate. In this

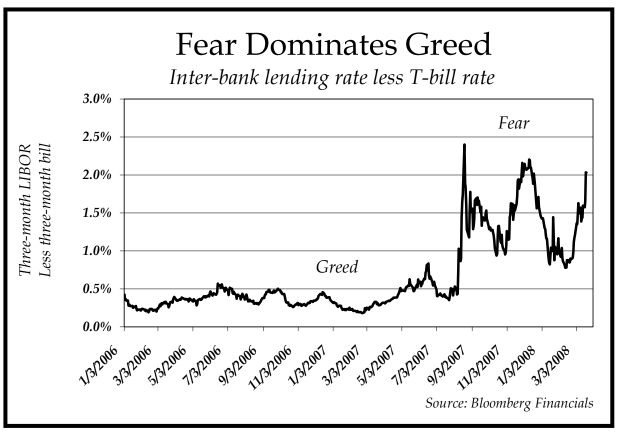
sense, the Fed adds dollars to the banking system in an attempt to stimulate lending and eventually jump start the economy. In this context, the supply of dollars is liquidity.

"Liquidity crisis" is when one or more financial institutions have difficulty getting funding. When the financial world is uncertain of the survival of a company, it refuses to lend it money. Again, liquidity refers to money, but in this instance it refers to the availability of funds to a specific financial institution.

Lastly, liquidity can refer to the ease and speed with which a financial transaction can occur. For example, a Treasury bill is a liquid security, because it can be bought and sold in a matter of seconds and at a very small cost. On the other end of the spectrum, a subprime mortgage-backed bond is now very illiquid, because virtually no one is willing to buy one.

Federal Reserve Actions

Recent Federal Reserve actions have attempted to improve or maintain liquidity at all three levels. Dramatically cutting the Federal funds rate has added money to the financial system. This is the traditional financial tool of the Fed and addresses liquidity in the first sense defined above. The Fed has also taken unprecedented steps to address liquidity problems in the other two forms.



After posting large subprime write-downs, most banks have become skittish about lending to one another. In response, the Fed created the Term Auction Facility (TAF), which allows banks to borrow funds for a 28-day period directly from the Fed. Banks must put up securities as collateral for these loans. This innovative backstop for the banking system has assisted in preventing a banking crisis.

A smooth functioning market for securities is also critical to the economy. In March, the Fed created a Term Securities Lending Facility (TSLF) and Primary Dealers Credit Facility (PDCF) for their network of primary dealers. These 21 institutions are the only broker-dealers that trade directly with the Fed. Through the TSLF and PDCF vehicle, the Fed is now lending money directly to Wall Street and providing a backstop for the securities dealers to prevent a drying up of their funding.

By accepting securities as collateral, the TAF, TSLF and PDCF not only provide funding to banks and dealers, but they also help finance the banks' and dealers' holdings of securities, particularly mortgage-backed securities. These are not subprime mortgages but largely conventional, high-quality mortgages. Most have the backing of Ginnie Mae, Freddie Mac, and Fannie Mae agencies. By keeping the mortgage-backed bond market liquid, mortgage interest rates will be kept to reasonable levels. Lower rates and new sources of funding are providing critical liquidity for the securities market.

How Did This Mess Happen in the First Place?

Financial innovations over the last 10 to 20 years have created an alternative banking system. Sources of funds are cheaper and easier to obtain than through the traditional banking system. Some have called this the "shadow banking system." The traditional banking system is regulated; banks' loans are constrained by the amount of capital on their books. The alternative banking system includes collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), asset-backed securities, real estate investment trusts (REITs), and hedge funds.

These vehicles and entities have no regulator or funding source beyond the open market. The ratings of Standard & Poor's and Moody's are the only formal oversight of these vehicles. In the case of subprime lending, greed reigned supreme over all participants in the chain of the process: the homebuyer thinking house values would go up forever, the mortgage broker earning their fees, S&P and Moody's earning their fees for providing ratings, Wall Street earning its fees for selling the CDOs, and the eventual CDO buyer earning a little higher yield.

Greed overruled any thought of closer scrutiny of the quality of the underlying mortgages. In recent months, there has effectively been a run on the "alternative bank" of CDOs. No one is willing to buy them or finance them. The alternative banking system is fragile, because it is highly leveraged and its only source of funding is the open market. Since the Fed is not a lender-of-last-resort to the alternative banking system, liquidity can dry up overnight.

The first to be hit were large holders of subprime-related bonds: some hedge funds and structured investment vehicles (SIVs). SIVs owned by Bear Stearns, Citigroup, and Merrill Lynch have made the news, and those companies have taken major write-downs on those subprime assets. The effects of the large losses are now rippling through all the markets.

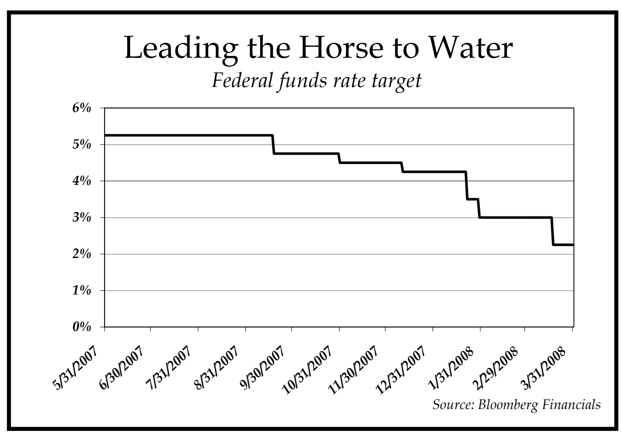
Until now, bond insurers, such as MBIA and AMBAC occupied an obscure corner of the investment world. In the 1990s, revenues from insuring municipal bonds reached a plateau, and revenues from rating structured investments, such as CDOs, were accelerating. Now the bond insurers are liable for future missed interest and principal payments on subprime-backed bonds. With the health of the bond insurers now in question, interest rates for many municipalities have gone up.

With the outlook for U.S. economic growth weak and U.S. assets declining in price, the dollar has become less attractive to international investors and continues to slide. In the wake of the declining dollar, capital has sought safe haven in gold, oil, and other commodities. Gold has been anointed the title of the "anti-dollar," since gold's value now correlates inversely with the value of the dollar.

The Fed Has Led the Horse to Water

The Federal Reserve is certainly committed to preventing a collapse of the financial system, and we have no doubt they will succeed. The bigger question is for the economy as a whole.

Plenty of funds are in the financial system, but how much and how long will banks restrain lending. How long will investors be reluctant to invest? In other words, the Fed has led the horse to water, but will the horse drink? Liquidity is more a state of mind than a measure of money in the financial system.



When Will the Bad News End?

In short, the financial system needs to purge the losses on subprime loans from its system. At this moment, no one knows how large the ultimate losses will be. Based on past mortgage default experience, we expect delinquencies of subprime loans to peak sometime in the third quarter of this year. This will start a process of a more accurate accounting of losses, and within a few months the financial landscape should start to stabilize, allowing markets to look ahead to more favorable times. In the meantime, we remain cautious, expecting heightened volatility and a deteriorating economy.

Professional Profile:
Ralph Cole IV, CFA

If there's a theme to the nine years since we last profiled Ralph Cole, it's clearly growth. Cole joined Ferguson Wellman as its first analyst. Now he looks at his career, and the firm itself, and sees the arc of a distinct evolution. "Part of the process for me was blazing my own trail, with the support of the principals," he reflects. "I've figured out how to do what I'm good at, and I've taken on new responsibilities." Today he's in charge of the firm's global financial sector as well as the firm's international and REIT strategies. It's a suite of assignments well matched to a diligent researcher's skills.

Ralph and Patty Cole in 1999, expecting their first child

In the last couple of years Cole has also managed a small number of client accounts. Person-to-person contact balances the close analytical tasks he engages in for most of the day. "Working with clients helps me better understand what they expect from us and what their concerns are," comments Cole. In turn, he feels, "I can offer my clients a lot because I touch their portfolios in so many ways."

Being an analyst can have a bit of an ivory tower feel about it. "In my specialty, you tend to get tied up in the numbers," he admits. That's why Cole appreciates the grounding he gains by engaging directly with clients. "Clients provide the common sense perspective."

The Cole family in 2008
Clockwise from the top left: Patty, Riley, Holden, Ralph and Aidan
Photography by Bruce Beaton

Cole found his career direction uncommonly early. "I started picking stocks in a junior high school class, and it's still my passion– it's what gets me up every day." He calls it the best job in the world because it amalgamates everything he's learned about the economy, marketing, finance and business strategy. "No other job ties it all together the way picking stocks does," he states. "And I like that it's quantifiable: every day you watch the scorecard and you get to see how it plays out. You're always learning and always adjusting. There's this feedback loop that's more immediate than any other job."

In an industry subject to cyclical storms, Cole has the calm demeanor and steady hand at the tiller that keeps clients from feeling jostled. "We take this very seriously – and very personally," he says. "We take pride in protecting our clients."

Despite the changes in his own position and the growth of the firm, Cole points out substantial areas of continuity. Since the day he started, Cole has reported to the firm's chief investment officer, George Hosfield. The next generation of owners remains the same, with Cole being one of five professionals continuing to acquire more shares and increase the number of clients they serve. "It's reassuring," he says. "Our clients always come first. What we promise to deliver, we deliver. The more it changes, the more it stays the same.

There's been significant growth in another area since the Coles were highlighted in *Market Letter*: their family. Nine years ago, eldest son was not yet born. Now Holden (the Coles vetoed the idea of a Ralph V) has a brother, Aidan, who's seven, and a sister, Riley, who's three. For Patty Cole, it's a full-time job managing the brood in their Eastmoreland home. "She's amazing," says Ralph appreciatively. "She keeps it all together."