



September 17, 2008

Overview of Recent Market Events

In light of the recent unprecedented news regarding Lehman Brothers, Merrill Lynch, and AIG, and following the government's takeover (announced last week) of Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Association), we wanted to share our views on the unfolding global financial crisis. We will not explain in detail what happened with each organization, as the news media have extensively covered these events, but rather, review what led to the crisis, some of the risks still prevailing in the market, possible positive developments, and finally our recommendations.

First a brief review of recent market events:

- On September 7, the Federal Housing Finance Agency (FHFA) announced their decision to place Fannie Mae and Freddie Mac into conservatorship run by the FHFA
- On September 15, Lehman Brothers Holding Inc. filed for Chapter 11 bankruptcy protection
- On September 15, Merrill Lynch announced it would be purchased by Bank of America
- On September 16, the Federal Reserve announced an agreement to provide an \$85 billion emergency loan to rescue insurer AIG

All of this follows several bank failures, a substantial decline in residential real estate values, increased foreclosures, higher unemployment, and a slowdown in the U.S. economy that has led to a heightened sense of slower global economic growth. What happened to cause all of this turmoil in the first place? To answer that question, we need to review why institutions such as those mentioned earlier (in addition to many other market participants) took excessive risks that ultimately contributed to their downfall.

Prelude to a Credit Crisis

Following the recession of 2001, the Federal Reserve sought to stimulate the economy with an easy monetary policy by substantially lowering interest rates. This ultimately led to an abundance of liquidity and "easy" credit, inducing the potential for "moral hazard." Many have argued that the Fed was too accommodative for too long, leading to the credit problems we face today. In fact author and investor, Marc Faber, said it well when he commented that "a surplus of cash led to a shortage of sense."

From 2003-2006, we observed a market environment of low interest rates, modest inflation, low unemployment, and strong global GDP and corporate earnings growth. Many believed the market was in the best shape ever with little cause for concern. Amid the seemingly endless global glut of liquidity, market participants extrapolated this "good news" into the future without considering potential pitfalls along the way, such as the fact that real estate values do not increase 10% every year. Skeptical market observers commented that the markets were "priced to perfection" and even a small hiccup would cause these conditions to deteriorate. With Wall Street and its professionals earning huge profits amid the liquidity infused bull market, few were willing to question the sources of these extensive profits and re-focus on risk management. Problems in the subprime mortgage market ultimately proved to be the catalyst skeptics were worried about, leading to the deterioration in the markets we are experiencing today. Essentially, the mortgage lending market let greed interfere with good business judgments, leading to higher delinquencies and foreclosures.

Subprime mortgage lenders were not alone in providing “easy credit” however, as leveraged buyout activity reached record levels in the first half of 2007. Lending among the investment banks and what has become known as the “shadow banking” industry (i.e., unregulated financial institutions that act as lenders) were heavily leveraged as a result of the glut in global liquidity. Even the lowest quality companies had ready access to capital with favorable pricing, including what became known as “covenant-lite” financing, where few if any covenants could be triggered that would lead to default. With a ready supply of securitized buyers in the CLO (collateralized loan obligation) market to buy this paper, banks continued to lend without concern for the quality of the loans they were making.

By July 2007, the CLO market shut down completely, as investors in the CDO (collateralized debt obligations) market experienced material losses in their securitized investments. Other opaque areas of the fixed income markets were negatively impacted as well, as a full blown credit crunch was underway.

Up to this point, the poor credit quality inherent in mortgages, CLOs, and other securitized investments could not be ignored. Lenders providing the short-term credit to finance investment bank activities required more collateral for loans as they were suffering heavy losses. The funding for on-going investment banking activities dried up as risk appetites became non-existent, forcing investment banks to dip into cash reserves, which lowered their credit ratings and prompted lenders to seek more collateral, continuing the vicious cycle that caused Lehman Brothers to declare bankruptcy and Merrill Lynch to seek a buyer.

Risks Prevailing in the Market

While the markets are evolving daily and these situations are fluid, we believe the primary risks remaining in the market are:

- **Additional broad equity market declines:** As further news develops, additional negative news may create uncertainty, leading to further declines.
- **Availability and the cost of credit:** The obvious impacts of a tight credit environment are thought of in terms of lower quality borrowers, however, the impacts could be farther reaching. For example, U.S. Treasuries have been a safe haven in the flight-to-quality over the past year. According to JP Morgan, nearly 60% of U.S. debt securities are held overseas. If foreign investors were to lose faith in U.S. debt as a store of value, or merely begin taking risk for their own long-term investment purposes, interest rates in the U.S. could rise, thereby making credit more expensive and decreasing the rate of economic recovery.
- **Further commercial bank failures:** Commercial banks seeking to shore up their balance sheets through additional funding have met with difficulty in finding lenders; the FDIC also appears to be underfunded to meet its obligations should larger institutions begin to fail.
- **Counterparty risk:** The failure of large investment banks such as Bear Stearns and Lehman Brothers increases the potential for additional counterparty defaults on various derivative contracts, with outcomes that are impossible to quantify in an opaque and unregulated area of the market.
- **Unintended consequences from regulatory response to financial crisis:** As politicians seek to prevent a recurrence of recent events, there is risk of a “regulation overshoot” that could harm the economy and impede a recovery.
- **Future of remaining investment banks:** Of the five primary investment banks that stood at the beginning of the year, the fate of Goldman Sachs and Morgan Stanley as independent investment banks remains uncertain.

Positive Developments as a Result of the Crisis

The current credit crisis is likely to lead to several positive developments for long-term investors, some of which are:

- Excesses in the market are being eliminated through rapid de-leveraging.
- A renewed focus on risk management is likely to lead to more sound decision making among market participants.
- The re-establishment of risk premia in various asset classes provides opportunities for investors to exploit on an un-levered basis.
- The forced selling of assets from bank balance sheets provides opportunities for investors willing to provide liquidity to acquire assets at substantial discounts.
- Reduction in moral hazard through the decision to allow some seen as “too big to fail” to in fact fail (e.g., Lehman Brothers).
- Market participants focused on sound lending practices and thorough due diligence are more likely to lead to a more stable economic environment.

Recommendations

One of our primary tenets is to focus on the long-term and not let short-term market volatility deter investors from their investment objectives. This is much easier when investors are not heavily concentrated in a few areas (or highly leveraged). We have steadfastly recommended that portfolios be broadly diversified, both among and within asset classes. The addition of uncorrelated assets to portfolios helps to dampen volatility and can also increase expected returns.

Although being patient and maintaining discipline through difficult market environments is not always easy, overreacting to recent events usually proves harmful. In the last two decades investors experienced the corporate accounting scandals (Enron, WorldCom, Adelphia, etc.), the sharp equity declines following the September 11 terrorist attacks, the bursting of the dot com bubble, and the Asian financial crisis in 1997, the savings & loan crisis in the early 1990s, and the stock market crash in 1987. The markets recovered after all of these crises and in many instances were stronger after the excesses were reduced. Frightened investors who sold after the losses did not fully participate in the rally.

Astute investors did not panic in these environments, but rather, sought to take advantage of opportunities created by market dislocations. In late 2002, for example, we recommended that clients reduce their exposure to core fixed income and increase their exposures to high yield, real estate, and equities, asset classes that were attractively valued after several years of weak performance. Investors had lost faith in the markets following the accounting scandals and were also concerned with the impending war in Iraq. This created opportunities for investors willing to decrease their exposure to “safe,” yet low yielding, bonds and increase their exposure to “distressed,” yet attractively valued, areas of the market. Today, we are actively seeking opportunities to recommend to clients, especially in distressed areas of the market where investors can purchase securities from forced sellers.

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While we recommend appropriate investment policies and seek attractive opportunities at the asset class level, day-to-day management of the portfolio remains the responsibility of the investment managers. One of our major responsibilities is to assist our clients in selecting these professional investment managers to oversee their portfolios. We are also responsible for monitoring the managers to ensure they are meeting the objectives they were hired to achieve.

For the last few weeks our research analysts have been contacting investment managers about their portfolio positions (first Freddie Mac and Fannie Mae and more recently Lehman Brothers and AIG) to determine if there is a need to review a manager or their allocation within a portfolio. In terms of hedge fund due diligence, we began contacting managers several weeks ago to determine their exposure to Lehman Brothers prime brokerage operations. We concluded that most hedge funds were eliminating/reducing their prime brokerage exposure to Lehman Brothers.

In conclusion, we are facing a challenging market environment with unknown risks, yet opportunities for those willing to prudently invest in out-of-favor asset categories. We recommend maintaining discipline in the face of troubling times, as we do not know when the markets will bottom and begin to recover. In the meantime, we will continue to actively monitor investment managers to ensure they are serving the role for which they were hired. If we uncover anything warranting special attention, we will notify you to determine next steps.