

October 8, 2008

## Is the Sky Falling?

Surely you have seen the daily news reports that would make it appear that the financial system is crumbling before our eyes. So is the sky really falling? In order to address this question we would like to go over the underlying problems within the financial landscape, steps we have taken recently and then go over what our outlook is for the future.

The news coverage continually makes references to esoteric financial instruments such as MBS, CDO, and CDS. Here is a quick primer on what these instruments are:

**MBS – (Mortgage-Backed Securities)** A security collateralized from a pool of mortgages. The principal and interest payments from the underlying mortgages are flowed through to the holders of the MBS.

**CDO – (Collateralized Debt Obligations)** These structured credit instruments are broken up into risk tranches that flow gains and losses from the underlying securities. The underlying collateral can be any type of debt, but currently most of the distress is from CDO's collateralized with MBS's.

**CDS – (Credit Default Swap)** This is essentially an insurance contract to protect against default. Companies that sold the insurance (AIG) have found that the default rates on the CDO's they insured are significantly higher than they had initially expected causing billions of dollars in losses.

The one common denominator among these different securities is that they all tie back to residential housing. Over the past decade both Republicans and Democrats pushed for higher home ownership rates which meant relaxing standards, decreasing or eliminating down payments, and coming up with exotic mortgages. This artificial increase in demand pushed housing prices way up and in turn created this boom and bust that we are left with today. Investors and lenders all believed that the collateral (Homes) were more important than the people promising to pay back these loans, but what is obvious now is that if too many people default on their loans then it directly effects the value of the collateral that you were counting on as insurance in the first place. J.P. Morgan is quoted as saying that credit is all about character and that seems to be as correct today as it was 100 years ago. The lesson learned here is that not everyone is cut out to own homes.

So the real problem that must be addressed by the government is to stop the rapid decline in housing prices that is leading to more foreclosures and lower prices. The \$700 billion dollar bailout package is designed to deal directly with this issue. It is not the panacea for all that ails finance, but it is definitely a forceful start. By recapitalizing the banks, buyers will be able to get loans to bring down the inventory levels and support housing prices. The purchases of mortgage securities will also give the government power to augment loans to keep more people in their

homes and out of foreclosure which will also help to bring housing inventories back down.

As a firm we had been in principal protection mode since late last year through the end of July. Towards the end of July we started to position the portfolios to start taking on a bit more risk. At that point the S&P had already fallen over 20% from its peak and we believed that this was a good starting point to start getting more exposure to the market. Of course since then a few small events took place:

- September 7th – Fannie Mae and Freddie Mac are nationalized
- September 15th – Lehman Brothers files bankruptcy
- September 17th – AIG is bailed out and is 79.9% owned by the government
- September 25th – Washington Mutual is seized
- September 29th – Wachovia is sold to Citigroup with government backstop
- October 3rd - \$700B bailout package signed into law

With these events the S&P has continued to decline another 20% for a total loss of 36.8% from the peak as of October 7th. Our portfolios have been able to cushion some of the losses but we have participated in the recent downside of the market. After the announcement of the bailout package we sold our position in Prudent Bear because we had achieved meaningful gains and the prospect of the government propping up the markets would be detrimental to this position. We also added to our DXKSX position which shorts the 10-year treasury. Our thought process there was that in order to fund a \$700B bailout the Treasury will have to add a significant supply of Treasury bonds which in turn should bring Treasury prices down. The holding was working against us due to fear pushing investors to the safety of Treasuries, but as you can see from today's (Oct 8th) announcement of auctions totaling \$40B in 10-years the yields jumped a full 20 basis points! This being only \$40B of what we estimate to be ~200B they will have to sell in 10-year maturities to fund the bailout.

Our medium term outlook continues to see weakness in the economy and volatility from continued deleveraging of the financial system. We do not want you to confuse our weak economic outlook as being the same as having a negative outlook on all asset prices. The one bright side to systematic sales of assets is that it creates opportunities to pick up high quality assets at incredible prices. The vulture investors such as Warren Buffet are starting to nibble so this is a positive sign for high quality assets in both the fixed-income and equity spaces. These periods show why it is important to work with a proactive investment advisor who works to actively cushion you on the downside. Those touting passive index strategies have watched their clients portfolios take a beating day after day and refuse to take responsibility because they do not feel it is their job. We take the role of protecting your money extremely seriously and we vigorously seek to achieve a balance between the growth needed to achieve your goals and the protection required for you to be able to sleep soundly at night. Please give us a call if you would like further clarification.

Thank You,

Excelcia Financial Group