The Repricing of Risk

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Let's place the recent credit market turmoil and stock market declines in perspective. For those of you who are regular readers of our strategy essays, you'll remember the following points from our piece, "**Bring the Boats Closer to Shore**" written in early February of 2007 (all Massey Quick research can be found at www.masseyquick.com on the home page under "Investment Strategy"):

- Strategies that employ large degrees of leverage will be at the center of capital destruction in any meaningful downturn.
- Credit spreads do not reward investors for default risk.
- The flat yield curve does not compensate for duration risk.
- The housing markets have cooled and may decline further.
- Default rates, particularly on sub-prime mortgages, are beginning to rise.
- Hedging is cheap. Put disaster insurance in place before volatilities rise.
- Equities were due for a correction.
- Hire Old Pilots (experienced money managers that have proven themselves over a series of market cycles).

In fairness to our readers, we were wrong on three fronts:

- Japan continues to disappoint. While exposure in most of our portfolios is small, it's painful to watch the Japanese market trip over itself time and time again. Even the most seasoned dedicated Japan managers are having trouble making money. I suspect we're getting out at exactly the wrong time but I think the recent pullback in the US market provides better opportunities.
- We expected unleveraged market neutral managers to benefit from increased volatility. They didn't. Instead their highly leveraged cousins were forced to sell the same long positions and cover the same short positions causing unfathomable and unprecedented drawdowns.
- We suggested it was time to take profits in emerging market equities. We were right, but way too early. Despite the significant pullback in the developed markets, the Shanghai Composite continues to hit new highs. I'm trying to sell all of the contemporary Chinese art I purchased in the late 80s when I lived in Hong

Kong. Chinese investors are still enjoying tremendous wealth creation. Outside of the Middle East, other emerging markets seem overextended.

<u>You Read the Newspaper – Here's a Brief Recap</u>

Indiscriminate use of leverage and aggressive lending practices caused a crisis of confidence that has impacted stock prices, interest rates, curtailed the availability of credit, and reduced the price of our homes. The pendulum had swung too far. Recently unsettled markets and higher volatility are the result of the realization that credit was too "easy". Some individuals, encouraged by mortgage lenders, took advantage of low interest rates and creative adjustable rate mortgages to purchase homes fundamentally out of their reach. Private equity firms bought entire companies financed by sub-investment grade debt at historically low spreads to treasury bonds. Large money center and investment banks provided bridge loans to the LBO shops to hold them over until permanent financing could be put in place. Pools of all types of loans were packaged, securitized, and resold to institutional investors in the form of CMOs (Collateralized Mortgage Obligations), CDOs (Collateralized Debt Obligations), and CLOs (Collateralized Loan Obligations), piling leverage upon leverage. The rating agencies (Moodys, Standard and Poor's, Fitch, etc.) rated these securities on their ability to pay interest and principal to the purchaser. It became evident, first in the mortgage market, that some of these loans would not be repaid. The ratings of some tranches of mortgage (CMO) debt became suspect. Hundreds of fixed income securities were downgraded by the rating agencies. The housing crisis was cutting deeper than expected. One only needs to look at the chart of WCI Communities, once considered a premier play on the growing Florida market, to understand how deep this cuts in some regions of the country.

2 Year Price Chart – WCI Communities

Investors who used leverage to help amplify returns were caught between a rock and a hard place. As bond prices fell, these leveraged investors were forced to liquidate their portfolios. By that point, there were few buyers willing to provide liquidity, even at lower prices. The sharks started to circle. Real capital destruction took place. Bear Stearns managed two highly leveraged mortgage funds that lost over $1.5 billion. Sowood Capital Management, another leveraged fixed income fund run by Jeff Larson, whose background included a 12-year stint at Harvard Management, lost 57% as the providers of his leverage forced him to liquidate portions of his portfolio. Days later, all of the fund assets were sold to Citadel Investment Group at distressed prices. In one fell swoop, the Harvard University endowment lost $350 million. To put it in perspective, this sum is higher than some endowments of quality liberal arts colleges.

These events, among others, caused a re-pricing of risk in the marketplace. Bond spreads, even on the highest quality corporate issuers, began to widen…quickly. Wall Street dealers, flush with their own inventory of lower grade paper, provided less liquidity at higher bid/asked spreads. In a matter of days, the bond markets went from complacency to chaos. Fearing that money center banks and investment banks were very exposed to a credit market meltdown that would impact their earnings and book value, financial service stocks were sold indiscriminately as holders decided to dump now and ask questions later. Investors sold riskier assets and placed the proceeds in low risk instruments like US Treasury bonds and money market funds. The yield on Treasury Bills dropped precipitously as investors flocked to safety. Please see the following chart depicting the yield on 90 day T-Bills during the past 6 months.

Chart courtesy Bloomberg L.P.

This is an over-simplification. The story has been covered in every major newspaper so extensively that we did not want to dedicate the bulk of this piece to history, but rather focus on guiding you through the storm. The one important takeaway is that **complacency about risk is over**. We have entered a new market environment. How should this affect asset allocation and manager selection for your portfolio? Let's review the major themes.

Three Core Risks Remain

There are three core risks to markets today that have the ability to cause equity declines of more that 10%. The first is inflation. The current Fed has biased their comments toward inflation concerns since Bernanke became the Fed Chairman in 2006. Our belief is that the inflationary bias will be mitigated by a continued crisis in the housing market, a less robust consumer and concerns about a slowing economy. We believe the Fed will cut interest rates before the end of the year. Inflation, in our mind, will not be a concern. This focus on the slowing domestic economy will cause continued weakness in the dollar versus most major currencies.

The next major concern is recession. Some are concerned that the bursting of the housing bubble will cause consumer spending to fall off of a cliff. It may. Combine this with increased financing costs for large and small businesses alike, and the impact that will have on earnings will be negative. We think the strength in corporate America will offset the weakness of the domestic consumer. Most corporate balance sheets are still underleveraged. Earnings growth may slow somewhat, but we don't think we'll enter the trouble zone. If the Fed acts to ease before the end of the year, putting the domestic economy before the defense of the dollar, we think the chance of a true recession is less than 25%.

The third factor, and clearly the wild card, is the ability of the financial system to weather the credit storm. The market will have to work through capital destruction in the bond markets caused by loose lending practices and the ensuing defaults. The leveraged players, as we have pointed out, have already been severely burned. Sowood and the Bear Stearns hedge funds only represent the beginning of a series of capital destruction events. Bridge loans, CMOs, CDOs, and CLOs are owned by banks, investment banks, insurance companies and mutual funds (yes, Joe Sixpack, this stuff may be in your 401K plan and money market account). While they may not be leveraged, there will be further write-downs of major proportions. The issues don't trade on an exchange – prices are not posted on a daily basis. The fact is, nobody is quite sure what the price of many of these instruments should be. It will all depend on how quickly the instruments must be sold. For Sowood, it was 50 cents on the dollar. Our greatest fear today is that a major foreign bank has a liquidity crisis. Many foreign banks presented themselves as counterparties of choice in the structured derivatives market through aggressive pricing. A counterparty default in the derivatives market by a foreign institution would cause severe dislocation in the financial markets. Katie, bar the door! It keeps me up at night. I don't think the string of bad news is over yet.

Liquidity Still Exists – It is Predatory Rather Than Opportunistic

The good news is that there is still a tremendous amount of liquidity in the system that can absorb a fire sale of distressed securities. This capital is in the savvy hands of hedge funds, private equity managers, and proprietary trading desks of some global investment banks (those smart enough to not get caught long and leveraged). Look for Berkshire Hathaway (Warren Buffet) and Icahn Enterprises (Carl Icahn) to be bottom-fishers. We're in for a bumpy ride that may last through the fall, but this paper will clear the market at a price. Those willing to step up and assume the risk at distressed prices will probably end up making boatloads of money. Bank of America's deal to purchase $2 billion of equity in Countrywide Financial in the form of a convertible preferred stock, announced on August 22, is a perfect example of the strong eating the weak. These providers of liquidity will become the arbiters of pricing. I wouldn't want to be on the other side of the trade.

The Fed Will Cut Interest Rates – The Yield Curve Will Normalize

We've been bearish on bonds for quite some time. The market for municipal (tax-exempt) bonds and taxable (corporate, treasury, and sovereign) has been decoupled for several years. We still think a core holding of high quality tax-exempts makes sense for most of our individual clients. We always espouse active management with a focus on credit quality. Investors should be increasing the duration of their portfolios now.

The taxable bond market is another story all together. For years we've believed that tight credit spreads have not compensated investors for default risk and the flat yield curve has not compensated investors for duration risk. That is all changing very quickly. The current credit shock will serve as a catalyst to normalize the yield curve and widen credit spreads. Massey Quick has strongly urged our not-for-profit clients to index their fixed income exposure or to own short to medium duration treasuries. We are now shifting our position to active management of fixed income, including corporates, sovereigns, and high yield. We suggest easing into this posture over the next 6-12 months (possibly sooner depending on market conditions). We are also searching for unleveraged long/short fixed income managers that can take advantage of volatilities in credit spreads and the re-pricing of capital structures.

The yield curve will normalize as short rates move lower and intermediate and long-term rates stay stable. Outside of the treasury market, credit spreads will widen, creating a further steepening of the curve. Investors will be rewarded for default risk once again. Hiring active managers to evaluate credit risk and portfolio construction will be very important.

Areas of Opportunity

- Stocks will continue to be volatile. We see a maximum peak to trough correction of 10-14%. Investors should buy on dips, hiring managers with years of strong fundamental discipline.
- A potential Fed easing will put continued pressure on the dollar. We are focused on managers that own large multinational growth companies. Allocations to international equity and fixed income should be increased. Dividends and dividend growth remain important.
- Unleveraged long/short equity will continue to be an extremely attractive asset class. Allocations to these managers should be at maximum levels.
- High quality banks and investment banks will overshoot on the downside as they continue to react to concerns about potential losses in mortgages, securitized debt, and bridge loans. They should be purchased at points of capitulation. ETFs should be used to gain broad exposure.
- The REIT market has seen significant declines. Yields are becoming attractive again. They should be purchased at points of capitulation. Again, ETFs provide well-diversified exposure to this bombed-out sector. Please see the following chart depicting the Dow Jones Wilshire REIT Index.

1-Year Daily Chart of **Dow Jones Wilshire Reit Index**

- Master Limited Partnerships have also come under selling pressure. Please see the following chart depicting the Alerian MLP Index. We believe this will continue to be a volatile sector and have begun to allocate to long/short managers who specialize in these securities.

Alerian MLP Index

- The yield cure will begin to steepen. This will happen as short rates drift lower and medium to long rates stay little changed, recognizing that investors do need to be rewarded for duration risk.
- Credit spreads will continue to widen and normalize, recognizing that investors will need to be rewarded for default risk. High yield spreads have moved from 260 bps over treasuries to 460 bps over treasuries in a matter of weeks.
- The municipal bond market will continue to be decoupled from the taxable fixed income markets, providing a safe harbor for individual investors. We continue to urge active management with a high degree of focus on credit research.
- For our foundation and endowment clients, we will slowly move away from our highly conservative approach to fixed income (indexing, short duration treasuries) to a more normalized asset allocation.

- The VIX, a standard measure of volatility, has spiked from complacent lows to multi-year highs. Capturing premium by selling covered calls against large core positions has become an excellent yield enhancement tool. Please see a chart on the VIX below.

CBOE Volatility Index

- Closed-end funds, traditionally a backwater for the investing public, are becoming attractive across a number of asset classes as discounts from net asset values increase. This will give investors a chance to own attractive sub-classes at 90 cents on the dollar.

We are closing the end of an investment era. Complacency is gone. Easy credit is now behind us. Risk is in the process of being re-priced. Expect higher volatility. Take a long-term view. As always, please feel free to call us with any questions or comments you may have.

Buy	**Sell**
Unleveraged Long/Short Equity	The Dollar
Unleveraged Long/Short Fixed Income	Contemporary Art
Large Multinational Growth Equities	Chinese Art
High Quality Financial Service Equities (on dips)	Domestic Consumer Equities
REIT Index (on dips)	Covered Calls
Master Limited Partnerships	
Active Fixed Income Management of Domestic and International Bonds	
High Yielding Dividend Growth Stocks	

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