



Now What?

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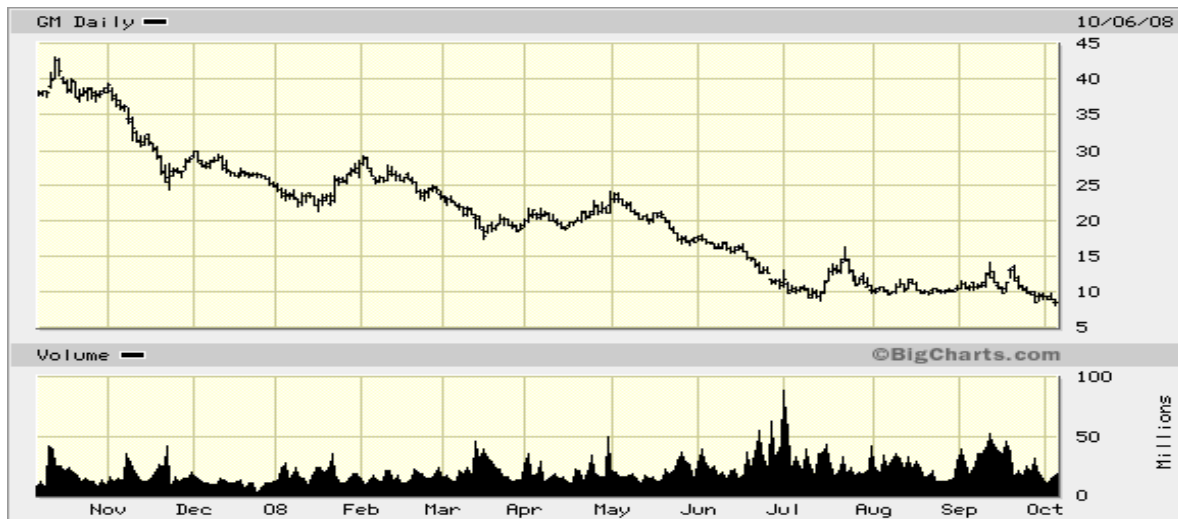
Very Few Places To Hide

The credit crisis moved into full bloom in late September and early October, freezing credit markets, demolishing stock market valuations and creating a real sense of fear and panic across world markets. US government intervention in the form of backstopping troubled financial companies and aiding acquisitions (Bear Stearns, Fannie Mae, Freddie Mac, WAMU, Wachovia and AIG) hoped to slow meltdowns of the mortgage and derivatives markets. European regulators also stepped in to rescue banks, mortgage lenders and insurance companies by guaranteeing deposits, forcing mergers and backstopping troubled companies. Traditional bastions of corporate strength were forced to enter into highly dilutive and expensive transactions in order to bolster their balance sheets and stabilize their stock prices (Goldman Sachs, Morgan Stanley, GE). Regional banks and other financial concerns were forced to accept ridiculously expensive capital, forcing even higher rates of dilution upon their shareholders in order to stay alive. Some didn't make it. Lehman Brothers, Indy Mac and a series of banks disappeared off the face of the earth in the blink of an eye. A significant amount of shareholder capital has been permanently destroyed with more downside surprises likely to come.

The Treasury, with assistance from the Federal Reserve Bank and the SEC crafted a rescue package (TARP – Troubled Asset Relief Program) designed to remove distressed assets off of the balance sheets of undercapitalized financial institutions. Watching the bill move its way through congress and the senate was a bit like watching sausage being made. The legislative process didn't help bring confidence back to the capital markets. The crisis is taking on global proportions. Finance is a cross border business. One can argue that Europe is lagging the United States in the recognition and resolution of their own series of meltdowns. What we hope to accomplish with this piece is to provide a roadmap for our investors to help them navigate through the carnage.

The Core Problem Is Credit

If you reference our previous strategy pieces (www.masseyquick.com), we pointed to the dangers of the unprecedented leverage being built up in our financial system. Credit was easy to come by. Interest rates were so low that lending institutions gorged on inexpensive capital, at times below the real rate of inflation adjusted cost, and relaxed traditional credit and collateral requirements for customers at historically tight spreads. We've all read about low documentation, no documentation and sub-prime mortgages. Banks offered these uniquely structured loans to make borrowing less expensive for potential borrowers. These "teaser" rates incited questionable home purchases by those, in hindsight, that couldn't afford to pay. Loans also served to support highly geared transactions in leveraged buyouts and private equity deals. These loans were packaged in the form of CMOs (Collateralized Mortgage Obligations), CDOs (Collateralized Debt Obligations) and CLOs (Collateralized Loan Obligations). When the housing bubble popped, the value of the underlying mortgage collateral declined, placing stress on the underlying securities. The precipitous drop in housing prices placed recessionary pressure on the economy, reducing consumption and capital spending, and putting downside pressure on collateralized loans. One has only to look at the price chart of General Motors to understand the severity of the slowing economy, credit constraint and a leveraged balance sheet.



Courtesy of bigcharts.com

As the value of these loans declined, the balance sheets of banks, brokerages and insurance companies deteriorated. Lenders became increasingly cautious, preserving what liquid capital they had left. Instantly, the system became credit constrained. Consumers found it difficult to borrow to buy homes, cars and big screen TVs. Home equity loans, once known as "ATMs in the living room" all but dried up. Like consumers, the credit markets closed or became more expensive for corporate borrowers. A crisis of confidence developed. Banks stopped lending to each other to avoid losing the game of financial musical chairs. The system became locked. Many credit instruments were essentially frozen as a buyers strike emerged. Something as simple as the commercial paper market, traditionally a source of short term funding for many corporations, seized up causing several money market funds to "break the

buck” or become illiquid. Stocks declined, some without regard to the underlying fundamentals, on concerns the credit freeze would exacerbate a slowing economy.

In order for markets to normalize, the balance sheets of financial institutions must be repaired. The government rescue package hopes to jump-start that process. As bad debt is removed from financial institutions at pennies on the dollar and companies continue to bolster equity capital, liquidity should return and the equity markets will return to a reliance on fundamental valuation.

The Good, The Bad and The Ugly

What will emerge from this carnage and uncertainty will be a separation of companies into The Good, The Bad and The Ugly. The Good will include companies with strong balance sheets, cash flow and earnings power. They will gain pricing power and market share. Some will attempt takeovers of weaker competitors, further consolidating their market position. This is already becoming evident in the financial sector as JP Morgan, Berkshire Hathaway and Wells Fargo, among others, pick over the assets of weaker institutions. The Bad includes companies that will make it through the crisis, taking time to repair their balance sheets and adjust their business models. They may find themselves somewhat credit constrained. Corporations in this category will languish for a period and may become takeover fodder for The Good and leverage buyout firms that specialize in restructurings and turnarounds. The Ugly may not survive. Companies in this category will find themselves highly credit constrained when the cost of capital exceeds the return on capital. They will be unable to access the capital markets. Smaller financial institutions and highly leveraged small and mid cap names will suffer the most.

From Chaos Comes Opportunity

It is difficult to predict when the credit freeze will begin to thaw. While the world’s central banks have been scrambling to provide some relief in their own countries, at the time this was written, there was no globally coordinated effort proposed by the G-7 to solve the global financial crisis that brought assurance to investors. We are heartened by the globally coordinated series of interest rate cuts and liquidity injections will have taken place to augment the efforts that were already put into place to shore up the system. One can argue the merits of our government’s plan, but given the rapid deterioration of the markets over the past two weeks, the Treasury and Fed should be commended for their leadership and decisiveness. European and Asian central banks must present a cohesive action plan instead of isolated reaction to one off situations. It could take weeks, or it could take months. At some point the credit markets will begin to normalize and investors will start to regain confidence.

When we speak to our equity managers, one clear theme runs through each of our conversations. Pricing in the equity markets is being driven by global macro factors, not company fundamentals. Pricing for some fundamentally strong companies is completely irrational. Once the credit markets normalize, we expect a return to rational pricing of equities. Good bottoms up fundamental analysis will rule the day again. The price anomalies created by irrational pricing will provide a wealth of opportunities for our managers. As always, we will focus our attention on “Old Pilots” with a long demonstrated track record of above average risk adjusted performance. As many of you are aware, our allocation to “long only” equity was historically low coming into this decline. At some point, it will make sense to increase these allocations. It boils down to a question of timing. The following is the track record of a value oriented manager we have been monitoring closely. Prior to 2008, he presented an outstanding track record. This has been a disastrous year as macro events have

taken precedence over fundamentals. After a significant amount of ongoing due diligence, we don't believe he and his team have turned stupid overnight. Psychologically, it is difficult to buy a manager after a tough run. These are the types of managers we may focus on when the time is right.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	S&P 500
2000	6.35	9.21	1.32	5.66	6.11	(2.17)	4.37	6.04	3.14	7.05	(3.43)	(1.78)	49.60	(9.12)
2001	4.55	(0.78)	(7.65)	13.05	3.90	(1.01)	3.08	(3.36)	(4.43)	1.14	1.45	3.49	12.61	(11.92)
2002	(2.27)	0.91	5.43	3.31	(0.08)	0.01	1.03	2.67	(2.87)	3.64	0.39	(1.44)	10.90	(22.06)
2003	(1.24)	(1.27)	2.79	6.74	5.87	0.23	2.33	2.69	2.10	8.55	1.38	3.06	38.14	28.68
2004	0.76	0.83	(0.63)	(1.70)	(0.16)	3.23	(3.29)	1.25	3.34	2.04	8.63	3.98	19.29	10.88
2005	(2.60)	2.69	(3.01)	(4.17)	8.61	1.46	5.19	(0.10)	4.88	(3.69)	4.60	2.12	16.15	4.91
2006	5.35	(1.89)	2.46	1.23	(4.15)	(1.75)	(2.00)	2.42	(0.03)	3.45	3.51	1.57	10.18	15.80
2007	4.33	(0.41)	3.30	3.88	5.20	(1.68)	(1.42)	(1.86)	7.62	6.96	(2.97)	1.60	26.61	5.50
2008	(12.60)	(1.00)	(6.30)	8.90	4.80	(6.30)	(9.70)	(6.10)	(15.10)				(37.59)	(19.28)

We also believe that unleveraged long/short equity and fixed income managers will be able to exploit the inefficiencies the market is presenting. Most of our managers have done an outstanding job of preserving capital. Most have historically low net and gross exposures. As one manager said to me this week, "Our job right now is return of capital, not return on capital. He will adjust his net exposure higher when he believes fundamental analysis, instead of macro factors, drive stock prices again. He sees equal opportunity to exploit opportunities on both the long and short side of his portfolio. His track record appears below. The track record of specific managers is not indicative of future performance.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	S&P 500
2004		1.76	0.16	0.39	3.03	2.88	1.14	(0.02)	3.92	3.60	4.43	2.96	26.95	8.88
2005	0.23	4.74	1.16	(1.95)	2.47	3.25	2.88	3.40	1.61	(1.84)	1.18	0.79	19.20	4.91
2006	2.33	(0.19)	1.24	2.44	1.60	0.43	1.37	0.67	0.93	2.13	1.83	2.36	18.51	15.80
2007	0.57	0.80	1.55	0.94	2.67	1.10	(0.27)	(0.17)	2.42	1.69	(1.75)	0.31	10.23	5.50
2008	3.19	1.09	(1.78)	1.53	1.59	(1.25)	(1.09)	(0.41)	(0.25)				2.54	(19.28)

These vastly different outcomes from two, arguably, outstanding investors underscore our philosophy of ample diversification of managers and styles.

The Future of Hedge Funds

Much has been written in the press about the future viability of hedge funds. We have always focused on long/short managers that do not rely on leverage to enhance their returns. We insist these managers have the vast majority of their liquid net worth in the fund. Side by side investing creates focus on capital preservation. All of them use robust fundamental analysis to structure their portfolios. These types of managers will survive and flourish. The leveraged hedge fund is all but dead. Some of these managers had negative returns of 15-20% in September. They will experience significant redemptions and many will go out of business. Hedge funds that rely on quantitative models to select stocks should also be avoided. We believe that the hedge fund industry will take on a "barbell" configuration. On one end, we'll have twenty-five or 30 mega funds managing multiple billions of dollars in multiple strategies. On the other end of the barbell will be a large number of boutique managers who limit capacity and focus on outstanding risk adjusted performance. We expect very few new formations over the next 12-18 months.

Short selling will survive. The abuses of short selling, particularly “naked shorting” (shorting a stock where the seller does not have a verified borrowing agreement), will be policed with vigor. The governments ban on short selling of financial related securities, while heavy handed, was probably the right course of action given the circumstances. We may see some adjustment in short selling regulations, including the reinstatement of the uptick rule, but hedging is still an important and vital tool in some styles of portfolio management.

Our Worry List

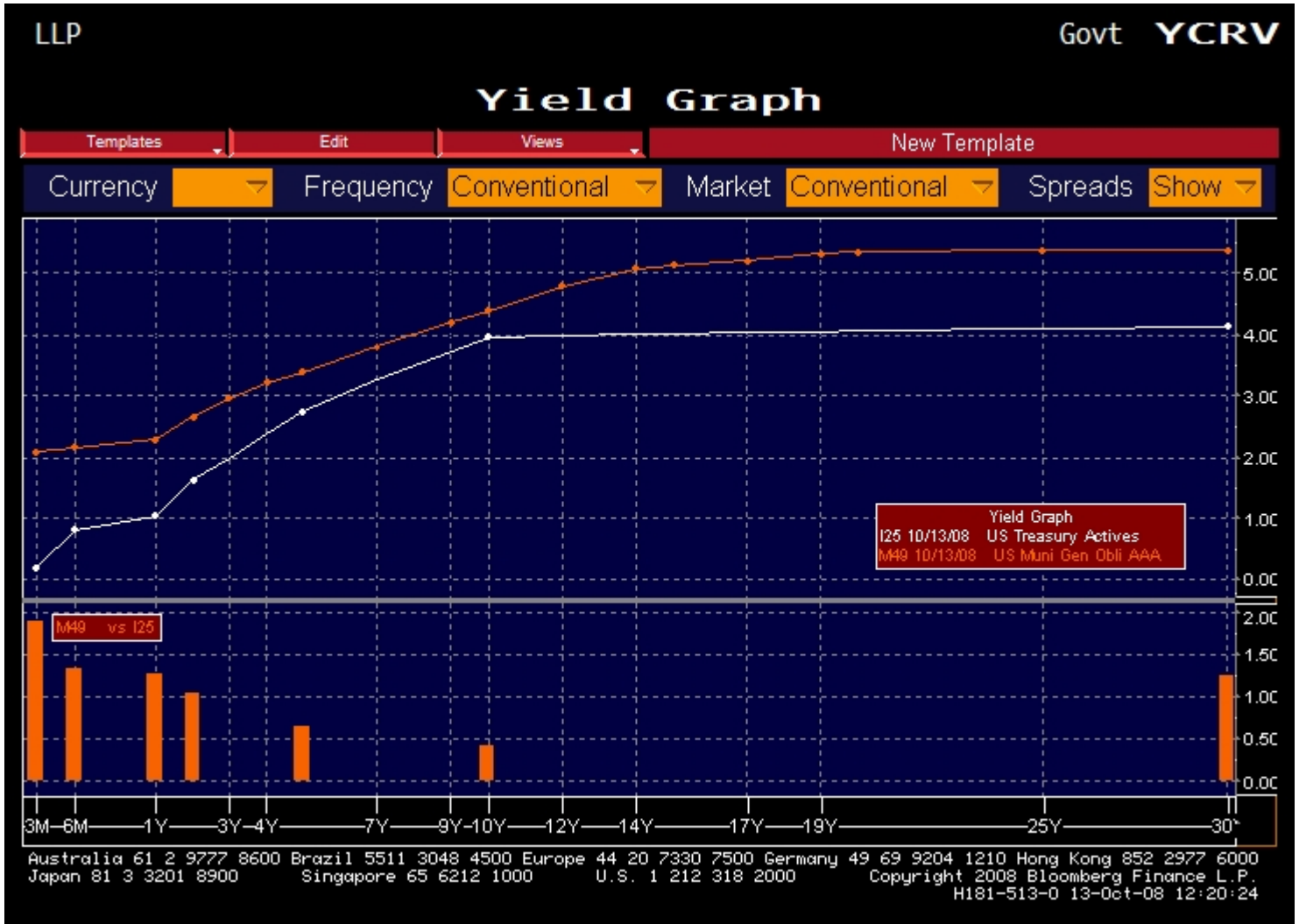
- While government intervention may help to stem the crisis of confidence, a global coordinated effort by the world’s major central banks does not emerge, extending the duration of the credit crisis. This battle can’t be fought on a transactional (AIG, Freddie, Fannie, Fortis, etc.) basis. There must be a truly global coordinated plan established to fight the battle. We need a clear and cogent action plan, not a series of reactions.
- If the freeze in the credit markets is cured and we return to some level of normalcy, the shock to the system combined with continued pressure on housing prices and a wary consumer pushes us into a deep and long recession. Under this scenario, corporate profits will deteriorate and equities will continue to be an unattractive asset class.
- Investors continue to lose confidence in markets, causing massive redemptions of mutual funds, fund of funds and hedge funds. This flight to liquidity would continue to put downward pressure on equity markets and interest rates, placing us in a “no return” environment.
- The multi-trillion dollar over the counter derivatives market, credit default swaps in particular, experience a waterfall of counterparties being unable to settle trades. We are strong proponents of a central clearinghouse or listed market for these types of instruments.
- A major terrorist attack takes place, exacerbating negative sentiment.

Fixed Income

The fixed income markets are clearly fraught with danger. As we predicted in our previous strategy essays, yield spreads between corporate and municipal bonds versus Treasuries have expanded to historic proportions. While we would avoid most corporate bonds until the credit storm passes, there are unique opportunities developing. Distressed fixed income investors take advantage of the fear and panic in the marketplace to purchase bonds they believe are oversold relative to their fundamentals. As forced selling continues to dominate price action, attractive situations will develop for distressed investors who have the ability to conduct deep fundamental analysis on credit securities, taking advantage of price inefficiencies and abnormalities. We believe that distressed managers will present outsized returns over the next two to three years. Over the coming weeks, we will be examining existing and potential managers to gauge how to benefit from this trend. Recommendations will follow.

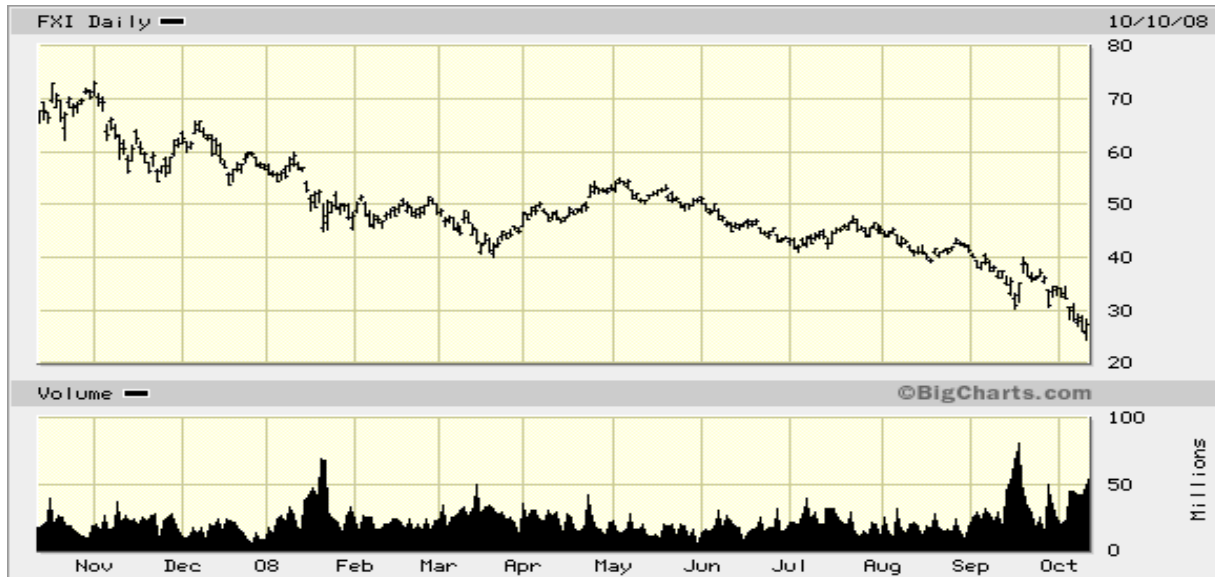
The other area of tremendous inefficiency now is the municipal bond market. In some cases, yields on the highest quality bonds are slightly below or comparable to yields of treasury bonds of equal maturity. Given the bleak economic outlook, many believe that general obligation and revenue bonds will be downgraded due to a decreasing revenue base to support interest and principal payments. The poor state of the bond insurers also brings doubt to lower quality bonds that sought insurance to boost their ratings to AAA. For this reason, we are focusing on bonds with strong underlying credit fundamentals and pre-refunded bonds. Pre-refunded bonds have their principal and future interest payments fully collateralized by US Treasury securities. This seems to be the safest way to take

advantage of the inefficiencies in municipal bond pricing. Rather than write a primer on tax exempt bonds, we would be happy to discuss this with you on a one-on-one basis. As always, we believe a fixed income portfolio should not be self managed. We hire managers on behalf of our clients that have a robust credit research process. A chart of the municipal yield curve treasuries appears below.



Emerging Markets

For quite some time now, we have advocated a zero weighting to emerging market equities. As global growth has slowed, we have seen deep and sharp declines. The following chart of the FTSE Xinhua ishare ETF shows a steep decline over the past year from a high of 73 to a recent low of 25.



Courtesy of bigcharts.com

The ishares Brazil ETF has moved from a 52 week high of 102 to a recent price of 34. Please see the chart below.



Courtesy of bigcharts.com

These markets seem to have begun discounting a worst case analysis. While growth has slowed in both countries, the economies are still expanding at a rate higher than that of the United States. We don't want to be a hero and "catch a falling knife", but we believe we are coming closer to a time to reallocate to emerging market equities. Our approach will be to scale in over the next several quarters. This timeline could be accelerated by continued sharp declines.

Time and Money

When we build investment policy statements for our clients, time is one of the most important factors governing asset allocation. Even with our absolute return approach, some clients think about their money in three year increments while others view their investments as perpetual capital. Swift declines and volatility have a tendency to force most to skew their view to the shorter term. This is human nature. It is tough to take a long term view in the midst of panic and capital destruction. It's time to reflect on the time frame that governs your capital. We are constantly evaluating managers and thinking about rebalancing and asset allocation in the context of each of our client's portfolios. Part of our job is to help you think through these issues in times of stress. We'll be proactive with you on recasting asset allocation and manager selection where appropriate.

Our Action List

When we think about allocations to certain asset classes, we think about price performance over a three to five year time frame. Markets may still come under pressure. As we have learned over the past few weeks, the declines could come lightning fast instead in the form of a slow steady decline. We need to remain nimble and opportunistic. All of the following ideas are presented in that context.

<u>Buy</u>	<u>Accumulate Slowly</u>	<u>Sell</u>
Long/Short Equity	Domestic Value Equities	Volatility
Pre-refunded Municipal Bonds	Emerging Market Equities	European Equities
Distressed Managers	"The Good"	Inflation Protection
	Blue Chip Energy Stocks	
	Blue Chip Oil Service Stocks	
	Blue Chip Technology Leaders	

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