CLIFFORD SWAN
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Credit, Confidence and the Current Market

By Ralph Weil, CFA

For the last year we have been forecasting a slowdown in the economy. Unfortunately, the combination of the economic slowdown and credit crunch has caused equity markets around the world to be very volatile and to decline more than was expected by us and most other professional investors. Understandably, we have been deluged with questions from our clients and other professionals about why this is occurring, how will the government rescue package help, and what actions we are taking as we move forward in this environment. We hope with this extended article to address most of these high-level questions by providing information that is as current as possible at the time of publication.

First, what is the real underlying catalyst of the current market downfall? The answer: the lack of access to credit at all levels of the economy and the corresponding freefall of confidence. In the spring, the government engineered a takeover of Bear Stearns, one of the oldest names on Wall Street. Due to fears in the marketplace about Bear Stearns' ability to repay its debt obligations, the market put pressure on the company to start reducing its debt. At that time, because of the kinds of illiquid investments the company held, it was not able to turn those investments into cash quickly enough to meet current needs. The resulting crisis of confidence made new credit unavailable to Bear Stearns, requiring the government to step in and arrange a takeover by J.P. Morgan to avoid a cascade of financial failures. Since then, we have seen a number of other actions taken by the Fed, allowing some companies to go bankrupt and others to be merged into stronger organizations.

We should realize that we are not only talking about credit drying up on Wall Street, but ultimately on Main Street. Today, retailers are having trouble financing holiday inventories. The State of California has approached the U.S. government for multi-billion dollar short-term financing due to problems in the municipal bond markets. Many people use credit and debit cards on a daily basis to pay for things instead of using cash. If the credit crunch continues to worsen, people may have to move to a cash-based society, just like the old days. This isn't just Wall Street's problem; it's everyone's problem.

How did we get into this position? And what does the sub-prime mortgage market have to do with it? At the beginning of the 20th century, mortgage lending used to involve a bank making a loan to a customer; the bank did its own due-diligence and kept the loan on its own books (e.g., George Bailey and the Savings & Loan from "It's a Wonderful Life"). Generally, the bank applied very stringent rules in its approval process to avoid holding a very poor credit and losing money on the transaction. In 1938, the Federal National Mortgage Association (Fannie Mae) was established to bring some liquidity to the mortgage market, but even into the 1960's most of the mortgages that were originated stayed on the banks' books. In 1968, Fannie Mae was converted into a private corporation to get it off the Federal Budget. In 1970, the Federal Home Loan Mortgage Corporation (Freddie Mac) was created to compete with Fannie Mae on equal grounds. Both of these organizations were established to create liquidity in the mortgage market.

With the success of Fannie and Freddie, the folks on Wall Street started putting together their own packages of plain vanilla Mortgage Backed Securities (MBS), backed by all these mortgages that Fannie and Freddie owned. In turn, local mortgage banks came to the realization that they could make more money (through gains and fees) and reduce risk

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MESSAGE FROM THE PRESIDENT

By *Peter Boyle*, CFA, CIC

"These are the times that try men's souls."

Thomas Paine penned these words in the opening of *The American Crisis* in December, 1776. George Washington used Paine's prose to motivate his discouraged troops who had just retreated across the Delaware River.

Today, we could use these same words in an opening dialogue discussing the current worldwide financial crisis; like Washington's troops, we could all use some encouragement.

It is in times like these that we perhaps provide our greatest value—sticking to our disciplines and investing for the long-term. In that vein, I want to offer one man's perspective on long-term investing.

This year observed the passing of the patriarch of a family who has been associated with Clifford Swan since the 1930's. Before his death at 91 years old, he witnessed the Depression as a teenager, the collapse of the Nifty Fifty while in his 50's, the S&L crisis and, more recently, the end of the tech bubble. During this same lifetime, he had the opportunity to invest alongside our firm's founding investors.

What makes this event worthy of mention here is not only his passing, but his wisdom and investment philosophy honed over his life and now shared via a message to his heirs. It is an important massage to remember, not only for the grounding it brings during a period of investment uncertainty, but also for its clarity and simplicity in articulating our firm's long-time philosophy to which he was drawn.

Almost ten years before his death, he left a hand-written message addressed, "To my successor trustee and heirs," in a safe deposit box. In the following paragraphs from this document, he lays out his perspective:

> "For two generations the family has been successful in accumulating (saving, not spending) capital; then investing it wisely. You are the beneficiaries of this success. Now you have to take over and maintain (at the least) and grow these funds. This you'll find takes thought, experience, and decisions —decisions!
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> ...The reason you have this estate is we've been in stocks and they've grown and grown. So, take the long view. Save something, and invest it in good business, good companies with good balance sheets (capital), good products, good management, and you'll be a winner."

Remarkably simple, but also true. Business, the economy and markets have recovered from every challenge they have faced thus far. Yet, economies, markets, and even investment firms are never perfect. All strive to learn from their mistakes and hope not to repeat the errors of the past. So, too, this time.

I now look forward to the newsletter in which I will quote Paine's words again using the opening from his final *Crisis* paper: "These are the times that tried men's souls, and they are over...." ◆

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(from their perspective) by originating mortgages and selling them off to either Fannie/Freddie or Wall Street. Because they were transferring the risk away from the bank or financial company, and giving it to third parties, the need for strict loan standards came down. There was now a large distance between the originator and the ultimate investor. In addition, the Street developed derivative products from the MBS's such as CMOs, IOs, POs, etc. These leveraged products escalated the risk and added to the house of cards. Wall Street took it to one more level by adding outside insurance to some of the derivative vehicles, which made the buyer of those issues feel safer. The demand for all these investment products grew in the 1990s and 2000s.

Fannie and Freddie were not alone in encouraging the lending boom. The Federal government also had a hand in

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helping "the monster" grow through both explicit and implicit directions. Back in 1977, the Community Reinvestment Act (CRA) was enacted to increase, in a significant way, affordable housing in urban areas. While the intentions were admirable, the end results have proven to be different than anticipated. Banks reduced lending standards and made more loans to less-qualified buyers. Fannie and Freddie were encouraged to purchase these sub-prime loans from the originators, again taking the risk off the banks' balance sheets and transferring it to some third party. This third party believed that he was buying into a pool of mortgages that, in essence, was insured by the U.S. Government, at least, implicitly. So the U.S. Government (U.S. taxpayer) took on the risk of all these loans, including, specifically, these sub-prime loans.

Pressure from the government on lending institutions to lower standards further surfaced again in the late 1990's, with prior and subsequent administrations perpetuating the policies which came before. In the end, the combined mandate of the CRA with Fannie and Freddie led to strong forces pushing U.S. housing prices and lending volume forward to peak levels in the 2000s.

Another thing the Federal Government did that encouraged speculation in housing was to change the tax law as it applied to a gain a taxpayer realized when he sold his residence. Prior to 1997, a taxpayer could defer a gain on the sale of his residence only if he purchased another home of the same value or higher than the sale price of the old residence. The 1997 tax change allowed an owner, after meeting a minimum residency requirement, to sell a home and get up to $250,000 ($500,000 joint) in gains tax free and then turn around and do it all over again. As real estate markets heated up from relaxed lending practices, this tax advantage added fuel to the fire.

As this mess was building, loan originators were encouraged to create more mortgages to meet the insatiable demand by Fannie, Freddie and Wall Street. Banks and mortgage companies began to change the focus of their business model to emphasize fee-based income as opposed to spread income (interest on loans). By receiving origination fees and servicing fees after the loans were sold, these institutions were incented to keep creating new loans to meet an ever increasing demand. Until recently, the Federal Government continued to encourage those loans to low income and less-than-credit-worthy borrowers.

With all that has happened, where did the breakdowns occur? ... When in doubt, follow the money.

So, with all that has happened, where did the breakdowns occur? First, it should be understood that if housing prices had not collapsed, we would not be in the position we find ourselves in today. That said, there clearly is enough blame to go around. Some of the major players include the White House, Congress, Wall Street, banks and ordinary people like you and me who could not afford the loans we took out. When in doubt, follow the money.

Fannie and Freddie benefited from the larger loan volume, mostly on the interest rate spread. Fannie and Freddie borrow funds at close to U.S. Treasury rates, which means they have a source of relatively cheap financing. The larger spread between their cost of funds and the mortgage portfolio that they hold for their own investment is a distinct advantage over the private sector. In addition, like banks, they moved some loans off of their books into mortgage pools and earned a servicing fee. By pushing more volume through the system, earnings were increased, and the managers of Fannie and Freddie earned higher salaries and bonuses as a consequence. Also, because the companies are publicly traded, the higher revenue and earnings caused their stock prices to rise and executives' stock options became more valuable—again rewarding top management at these housing finance behemoths.

Next, along came the Wall Street firms—like Merrill Lynch, Lehman, Bear Stearns, and others—with sophisticated financial models that allowed for the creation of derivatives which compounded the leverage of these mortgage pools. In other words, through the use of leverage on leverage, a bigger base of assets was created which in turn meant more fee income for the Street. This is really where the house of cards was being built, but the cards themselves were getting more toxic. The use of multiple layers of product all based off of one mortgage pool…times many pools…and utilizing sub-prime and Alt-A, high risk mortgages…created a high risk investment that was sold as a low or no risk vehicle, especially when wrapped with bond insurance and sealed by the credit agencies as "investment grade." It was in this environment that we saw the massive creation of structured investment vehicles (SIV's) and credit default swaps (CDS's), as well as the use of asset-backed commercial paper (ABCP) and other related products. A lot of people on Wall Street were complicit in this mammoth asset build-up which continues to unravel today.

Next, as we follow the money, we turn to Washington and the politicians. What is the benefit for the politicians that enabled, through legislation, and encouraged, by threat, the weakening of

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credit standards? Fannie and Freddie had one of the largest lobbying organizations in Washington and found ways to reward their friends in the Congress.

In the end, the net result of the creation of this credit house of cards is a liquidity freeze that threatens the world's financial system. In the cases of Bear Stearns, Lehman Brothers and AIG, their daily liquidity sources dried up due to illiquid mortgage related assets on their books. No one would lend them the funds they needed to continue their daily operations. They did not have time to wind down their own situations in an orderly manner and were forced into shotgun marriages or allowed to go bankrupt. On the bank side, we also have seen forced mergers with stronger banks, or the FDIC has stepped in to take over the failed institution. Again, it was bad mortgages and illiquid mortgage-related assets that were at the core of the failures. The surviving banks were flooded with cash by the Fed in hopes that they would turn around and start lending again. Unfortunately, that did not happen. Those banks held the cash to strengthen their balance sheets in order to make up for the write downs they were forced to take on their loan and investment portfolios. What we saw happening was an almost complete halt to lending. Small businesses that needed to finance inventories for future sales were not able to raise the funds they needed. Large, high quality companies like Goodyear, General Electric, and others had to seek out financing and bank lines to provide enough funds. The short-term borrowing markets shut down. If the credit squeeze had been allowed to continue, it would have eventually gotten to the consumer and limited their ability to get car loans, student loans or credit cards.

So what is the recent passage of the so-called "rescue" bill supposed to accomplish? The financial companies who have been suffering from the collapse of the house of cards have been writing down their holdings, thereby reducing their capital and limiting the amount of business they can do. The rescue bill is intended to stabilize the credit markets by putting a value on the underlying mortgages. The U.S. Treasury, by purchasing mortgages and the derivatives, will establish a floor and a price that should be above the fire sale prices that were being used for valuations on the books of financial companies. Prior to the acquisition by the government of those assets, banks were unwilling to even lend to each other, let alone to ordinary borrowers. They feared that the borrower might file for bankruptcy before they would be repaid. With someone (the government) willing to take toxic assets off of the banks' balance sheets, lenders should have more confidence that they will be repaid. The desired outcome will take time to be felt, but the positive steps should put us back on the right course.

In the interim, the market volatility continues as of this writing. As investors in this unsettled environment, our Research Team is stress-testing our assumptions about the capital markets and evaluating additional metrics to help us determine good value. While we remain cautious, we believe that the market is starting to present us with some attractive values in companies that we have been watching closely. These companies display many of the same characteristics as holdings in our current portfolios: strong market positions, strong cash flow, superior managements and high return businesses. In addition, we are considering the value of high-dividend paying stocks and deep-value issues as possible components in our portfolios.

We are constantly monitoring our current holdings to make sure that they still meet our requirements. We believe that as we go through the next few months, opportunities will emerge to either add to existing holdings or bring in new companies that offer greater value. As always, we welcome your questions and concerns. ◆