

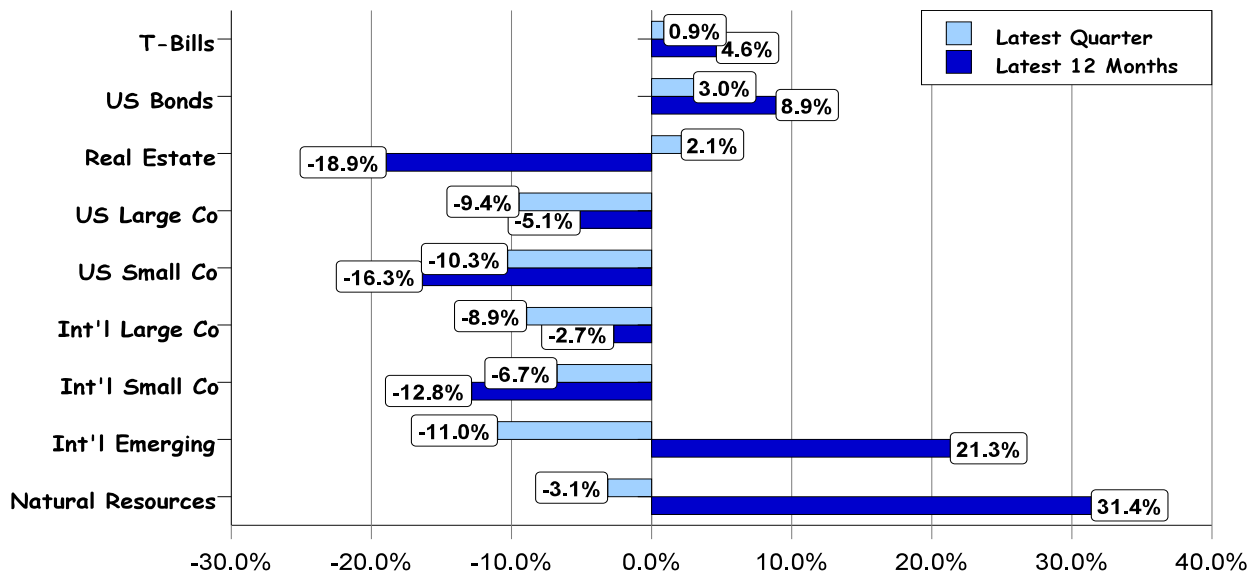
**Steady at The Helm (Part Two)**

Dear Client:

The investment markets have been in turmoil over the past six months and news from the financial press has been relentlessly depressing. The seemingly endless sub-prime loan crisis has worsened to the point where the US economy is probably facing its greatest challenge in over a generation. Following the end of the most recent recession in 2002, our economy enjoyed five years of remarkable growth fueled in large part by low interest rates, easy credit and rising home values. Unfortunately, all of this stimulus also helped create an unprecedented US housing bubble which is now deflating and bringing consumer spending down along with it. Accounting for two-thirds of overall economic activity, consumer spending is the lifeblood of our economic growth; so as home values fall and the costs of gasoline, food and other items continue to rise, the consumer is trying harder just to make ends meet, let alone find dollars for discretionary expenditures. On top of the consumer's woes, the economy is also saddled with the task of unwinding a vast amount of nonperforming sub-prime mortgages which were created during the housing boom and which have seeped their way into the heart of the investment banking system. So we're now faced with consumers who are hurting, house prices that are falling, a banking system under stress and a sagging stock market....just the ingredients to turn what was once a healthy economic expansion into a painful recession.

Recessions, of course, are normal aspects of the economic cycle, occurring about once in every eight years on average. The unique problem with this recession, however, is the challenge posed by the size of the housing bubble and the related sub-prime mortgage debt. Under a best case scenario, the housing bubble might deflate over the next year or two with only manageable harm to the economy and all of the nonperforming sub-prime debt might be worked out of the system in an orderly manner. Further, the strength of the global economy and demand for our exports might help offset some of the contraction here at home and lessen the severity of the recession. While there are a lot of "mights" in the best case scenario, there are clear indications that the Federal

**Asset Class Performance Comparison**



Reserve Board and other government agencies are taking steps to improve the chances for a smooth landing. More on the housing bubble later, but first, let's take a look at the most recent investment results which contain a few surprises.

### **Asset Class Performance Observations**

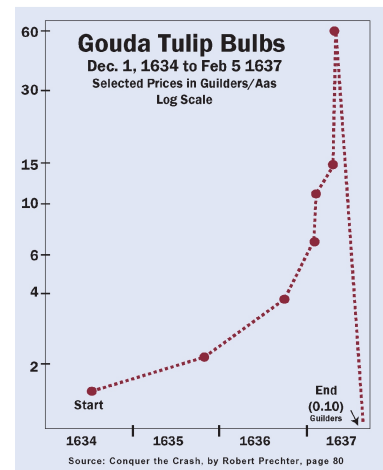
The returns for the quarter ending March 31st were surprising only in that Real Estate had the second best return (+2.1%) behind US Bonds (+3.0%). One might have expected Real Estate to have been the worst performer given the problems in the housing market; however, this asset class consists of Real Estate Investment Trusts (REITs) which own income producing commercial real estate (not single family homes). REITs were particularly overvalued in 2006 and early 2007 and share prices have fallen by about 30% from their peak, so the gain during the quarter reflects investor attraction to better valuations and relatively high yields of close to 5%. US Bonds were the best performing asset class due to an aversion to risk by most investors, i.e., while risky asset classes were falling, investors were attracted to the safety of US government bonds, hence their prices increased. T-Bills were the only other positive asset class for the quarter, but annualized yields on short-term treasuries are now less than 1.5% making them inherently risky on a long-term inflation-adjusted basis (i.e., with inflation exceeding 4.0%, a treasury yielding 1.5% is actually losing money over time). With the exception of Real Estate, all of the other stock asset classes were down between 3.1% and 11% for the quarter. In order, they are: Natural Resources (-3.1%), Int'l Small Co's (-6.7%) Int'l Large Co's (-8.9%), US Large Co's (-9.4%), US Small Co's (-10.3%) with Emerging Markets ending up in last place (-11.0%). Natural Resources were buoyed somewhat by the continuing, but slowing, global demand for energy and raw materials. The other stock asset classes were off across the board due to recessionary effects and fear of a deepening sub-prime loan crisis (as I mentioned above, stocks are off their first quarter lows so far in early April).

For the trailing twelve months, the biggest surprise was how well two of the more risky assets classes performed, Natural Resources and Emerging Markets. During a period of high stock market volatility, it was unsurprising that low risk asset classes fared well with US Bonds up by 8.9% and US T-Bills up by 4.6%; that's exactly what bonds are designed to do in turbulent times. And it probably wasn't too surprising that Natural Resources fared so well (+31.4%) given that the price of oil has risen to more than \$100 per barrel. The surprise was that Emerging Markets stocks gained 21.3% during a period when the S&P 500, thought to be a safer haven, fell by 5.1%. It wasn't surprising that US Small Co's (-16.3%) fell more than US Large Co's (-5.1%); that's been the consensus view for many years, plus smaller companies are riskier than their larger brethren. Nor was it a surprise that Real Estate fell by 18.9% given its spectacular run over the past five years. International developed markets' stocks were also down for the twelve months with Int'l Large down by 2.7% and Int'l Small down by 12.8%. Note that the international returns were somewhat better than the US stock returns due to the falling dollar which ends up increasing the return to US investors owning foreign stocks. In summary, returns over the past twelve months were sharply down with the exception of Bonds, Natural Resources and Emerging Markets. These three asset classes, in particular, helped to buoy our clients' portfolios which ended up with twelve month returns ranging from a loss of 3% for the more risky allocations to a gain of 4% for the more conservative asset mixes.

### **The Great Housing Bubble of 2001-2006**

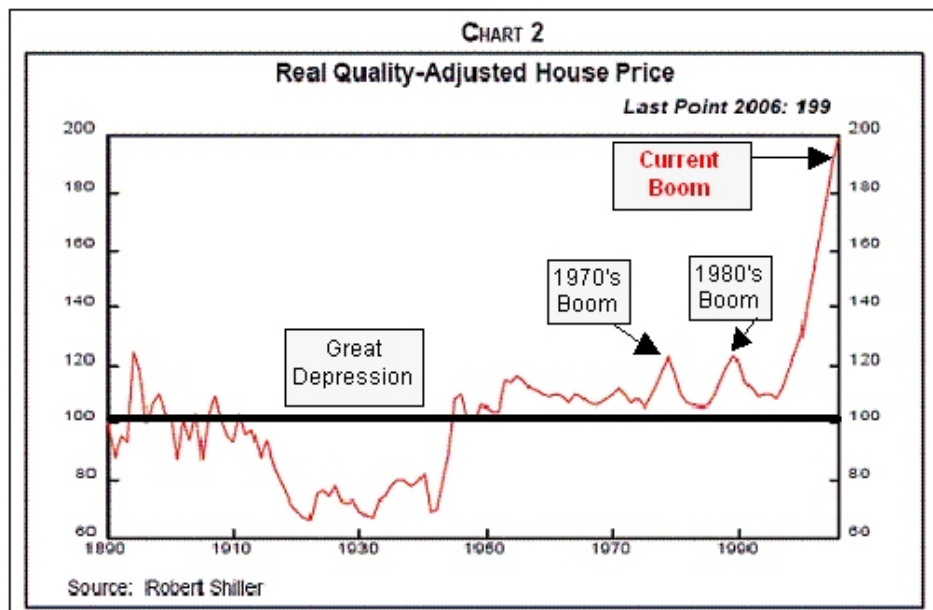
Financial bubbles have existed throughout history, one of the more famous being the Dutch Tulip Bulb Market Bubble in the early 1600's (say that ten times in a row). Having been introduced to Holland from Turkey in the late 1500's, the tulip became a highly valued flower by the upper classes. By the early 1600's, interest in tulip bulbs spread to all economic levels and eventually some of the more rare tulip bulbs were being traded by speculators on numerous stock exchanges. Believing that prices could only go up, investor mania took over and prices were bid to astronomical levels; in fact, the prices of the rarest tulip bulbs were sold for an amount equivalent to a wealthy person's annual income! Of course, all bubbles eventually deflate and the last ones to

participate in the mania end up facing financial ruin which is exactly what happened to many Dutch investors. Move the clock forward about four hundred years and we have witnessed the Tech Wreck Stock Bubble of 1995-2000 which saw technology stocks rise by 500%, and now, the Great Housing Bubble of 2001-2006. Robert J. Shiller, an economist at Yale University and author of *Irrational Exuberance*, studied housing prices dating back to 1890. In Chart 2 below, Shiller tracks the price of a standard house with adjustments made for inflation. Other than a period of depressed prices from about 1920 to the end of World War II, housing prices grew at an annual rate only slightly greater than the rate of inflation (represented by the straight solid line). Beginning in the late 1990's, however, the average house price rose dramatically with most of the gain occurring between 2001 and 2006.



What led to this sudden spike in home prices? There appear to be three key developments which created the "perfect storm" behind the housing bubble: (1) banking deregulation, (2) federal government programs designed to encourage first time buyers and (3) an era of historically low interest rates. In 1998, under the Clinton administration, new banking deregulation laws were enacted enabling non-traditional investment banks to compete in the mortgage business. Up to that point, mortgages were typically provided by traditional banks which followed strict qualification guidelines for borrowers. In 2001, the Bush administration encouraged home ownership as a means of promoting personal responsibility. One of his first actions was to introduce the American Dream Downpayment Initiative designed to assist low income households become first time homeowners. At the same time, Alan Greenspan and the Federal Reserve Board began lowering interest rates in order to revive the economy and encourage consumer spending during the recession of 2001. All three of these developments were extremely effective in achieving their objectives; however, the seeds for the biggest housing bubble in US history were also sown. While the causes behind the housing bubble are clear enough in hindsight, at the time no one was raising a red flag due to the fact that the housing boom was pulling us out of recession and into a period remarkable economic growth. Americans felt good about owning their homes and seeing their property values climb; and with things going well for the economy, no one was paying attention to another storm which was brewing just off the coast.

As house prices kept climbing, more and more potential buyers found themselves unable to afford a home under the conventional loan requirements (the old rules you and I had to qualify for, i.e., having a 20% down payment and earning enough to afford the monthly mortgage payment). The newly deregulated investment banks, being an ingenious bunch, came up with a new loan category to meet the needs of this growing group of potential home buyers, i.e., the infamous "sub-prime" borrower. The premise was that home mortgages were traditionally very safe investments and that house prices would keep going up so that even if the borrower



defaulted, the lender could always sell the house and recover the loan principal. Of course, sub-prime mortgages provided the potential for higher rates of return to their investors and in an era of historically low interest rates, there was a tremendous appetite for "safe" higher yielding investments. Investment banks, along with mortgage brokers, were making bundles putting together new "mortgage-backed securities" which packaged together both the traditional high quality mortgages and the sub-prime mortgages. By limiting the portion of sub-prime debt in the mortgage pool, the designers hoped to dilute their risk. Credit agencies agreed and awarded these new mortgage-backed securities with their highest credit rating (these are the same credit agencies, e.g., Moody's and S&P, which are paid by the investment banks to provide the ratings). Offering high credit ratings and higher yields, over \$6 trillion worth of mortgage-backed securities were sold to investors between 2001 and 2005, of which an estimated \$1.3 trillion is sub-prime debt. Investors include investment banks, hedge funds, state pension funds, foreign investors, high yielding bond funds, etc. All seemed well until housing prices began deflating and many sub-prime borrowers found themselves unable to pay their mortgages. Sub-prime borrowers, of course, were the most vulnerable and as the economy began to slow, they were the first group to experience default and foreclosure. A significant portion of the sub-prime debt is now deemed worthless and billions of dollars of related mortgage-backed securities are being written off (probably only a portion of the sub-prime debt will default). For the stronger investment banks which held only small amounts of sub-prime debt, the losses will probably be manageable, but for firms which depended heavily on the sub-prime business, the losses may be devastating. And of course, there are unwitting investors who will end up footing much of the loss.

### **Bear Stearns and Actions by The Fed and Others**

Over the past nine months following the bursting of the housing bubble, many of the investment banks involved in the sub-prime business have been forced to begin writing off their losses and it may take another year, or so, for the nonperforming mortgages to be flushed out of the system. Having been burned by mortgage-backed securities, investors have been reluctant to do business with investment banks which, in turn, has slowed the flow of money available for new mortgages and business loans. With a virtual freeze on easy and available credit, investment banking revenues are down and the financial viability of some firms is in question. The crisis was dramatized last month with the failure of Bear Stearns, once the fifth largest investment bank and major player in the sub-prime loan business. Under the weight of sub-prime losses, heavy leverage and poor management, Bear Stearns was on the verge of bankruptcy when the Fed Reserve Board, along with the financially strong JP Morgan, came to their rescue in an effort to forestall the sub-prime crisis from spreading to other investment banks. The Fed recognized the potential moral hazard in stepping in to bail out a troubled firm, but on balance they felt it was more important to stabilize the banking industry. The Fed has taken several additional bold and historic steps to provide liquidity to the banking industry, including the provision of \$400 billion through several lending facilities and lines of credit. According to Fed Chairman Bernanke, "The Federal Reserve, in close consultation with the Treasury, is working to promote liquid, well-functioning financial markets, which are essential for economic growth. These steps will provide financial institutions with greater assurance of access to funds." In other words, the Fed is committed to providing sufficient liquidity to maintain a fully functioning banking system.

The Department of the Treasury has also gotten involved by offering up a plan to expand the Federal Reserve's authority to act as trouble shooter in any area of the financial system which might pose a risk. In addition, lawmakers on Capital Hill are designing legislation to assist the most vulnerable homeowners and to tighten regulations on the banking system itself to prevent future sub-prime type problems (back to the future?). We can expect the customary congressional investigations and we'll undoubtedly see the all too familiar parade of culprits being marched off to jail. Of course, only time will tell how all of these measures will pan out, but it is reassuring that the powers at hand are grasping the seriousness of the crisis and are taking actions to improve the odds of achieving a best case scenario. One important sign the tide may be turning is the recent success in attracting private capital by two troubled firms with sub-prime exposure, Lehman Brothers (an investment bank)

and Washington Mutual (a mortgage lender). Further, the stock and bond markets seem to have stabilized somewhat over the past few weeks perhaps indicating that investors are beginning to see some light at the end of the tunnel. While these are positive signs, we're clearly not out of the woods, as most pundits see the markets remaining volatile for at least another twelve months. As investors, it behooves us to remain cautious, but not abandon our long-term portfolio allocation between high quality bonds and diversified stocks (i.e., steady at the helm).

### **Effect on Client Portfolios**

Of course, with any given crisis, there are safe places to invest as well as growth opportunities for long-term investors to take advantage of. One of the investing tenets of our firm is the concept of the "barbell" approach to investing. On one end of the barbell are high quality bonds and on the other end are stocks geared for growth. The bond side is designed to reduce overall portfolio volatility and to provide a safe haven during turbulent periods. The stock side is designed to generate growth in order to combat inflation and provide for long-term financial needs. The proper balance between the two is unique to each of our clients and dependent upon individual risk tolerance, but the average across our entire client base stands at roughly 45% in bonds and 55% in stocks. Over the past twelve months, the stock side of our clients' portfolios has lost about 5% while the bond side has gained about 6%; the total return for the average asset mix being just about break even (-0.3%). The lesson here is that overall portfolio risk can be tempered by establishing an appropriate mix of bonds and stocks.

### **Opportunities?**

During troubled times, potential "values" in the investment markets often emerge. For example, JP Morgan probably made a terrific deal in acquiring Bear Stearns at a bargain basement price. For individuals, one way to take advantage of depressed stock prices is through ownership of *value stocks*. Value stocks are characterized by higher dividend yields, lower price to book values, lower price to earnings ratios, and they're often companies whose share prices have been beaten down due to adverse developments (many more candidates are available today compared to a year ago). Value stocks entail somewhat greater short-term risk than growth stocks, but over the long-run, value stocks have provided significantly higher returns. For example, a dollar invested thirty years ago in the Russell 3000 Value Index would now be worth \$4,100 compared \$2,200 for a dollar invested in the Russell 3000 Growth Index. Growth stocks tend to perform best when the economy is expanding and when companies are rapidly growing their earnings. Another important opportunity to take advantage of lower stock prices comes through the process of *portfolio re-balancing*. While the stock market had been rising over the past seven years, rebalancing led to the partial sale of gains in stock mutual funds with the proceeds invested in bond funds. This systematic process has worked to effectively implement a *sell high and buy low* strategy (the opposite of what buyers at the top of financial bubbles tend to do). Today, stocks can be purchased at lower prices as we perform periodic portfolio re-balancing for our clients. Coupled with value stock investing, re-balancing can work to a portfolio's advantage over the long-run and help investors avoid financial bubbles at all times.

### **A Time of Hope**

In 1773, the English poet Alexander Pope wrote *An Essay on Man* in which he penned the famous line, "Hope springs eternal....." More broadly defined, this verse and his essay suggest that human nature tends to hope for the best, even when faced with adversity. Certainly we're facing adversity in the world today and our challenges are great, yet there are also reasons for hope and optimism. So, in closing, here's to life's springtime renewal and hope for greater peace in the world.

Sincerely,  
Warner A. Henderson