



Quarterly Commentary 2nd Quarter 2007

There is a hint of change in the air. No, unfortunately it is not that first whiff of fall that we usually get in late August or early September that brings hope that the dog days of summer will finally end. This is a different change, and the evidence of it, while small, is building. We speak of the ever so slightly noticeable change in investors' perception of risk. Most of the risk we see in the stock market is being driven by lax standards and speculation in the credit markets.

This story begins with easy credit and winds its way through the housing market, Wall Street brokerage firms, home financing, bank loans, hedge funds and private equity funds, before finally spilling over into the market for stocks.

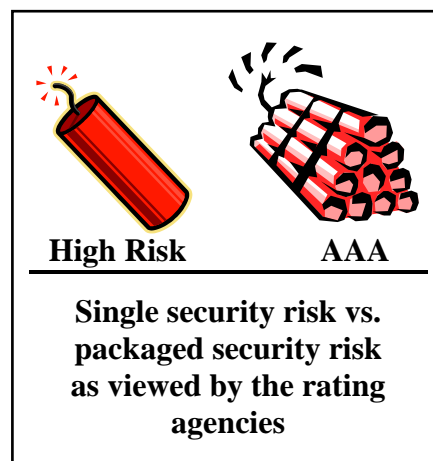
In last year's final commentary, we discussed the malinvestment that is fostered during boom times brought about by easy credit. (Don't worry; we are not going deep into money and credit creation again, so stay with us.) It is our belief that easy credit conditions have brought about significant amounts of malinvestment that will be laid bare in the next downturn of the economy. While we are not in a recession yet, the current slowdown is starting to create problems for investments in some assets. We believe that opportunities may be created as the issues from excess credit come home to roost.

We brought the potential for problems in the housing market to your attention during the summer of '04 in our special piece, "It's Time To Bust Up Fannie and Freddie." We again warned of speculation in housing that same year in our third quarter comments. That market peaked in the second half of '05, and the bottom seems nowhere to be found in housing at this point.

The ongoing housing debacle has triggered the humble beginnings of the change in risk perceptions we are now noticing. It seems some very aggressive investors, aided and abetted by Wall Street, poured money into

sub-prime (low credit quality) mortgages. These obligations had first caught the attention of several of the big players on the sell side, no doubt convinced of the marketability of the high yields on the paper.

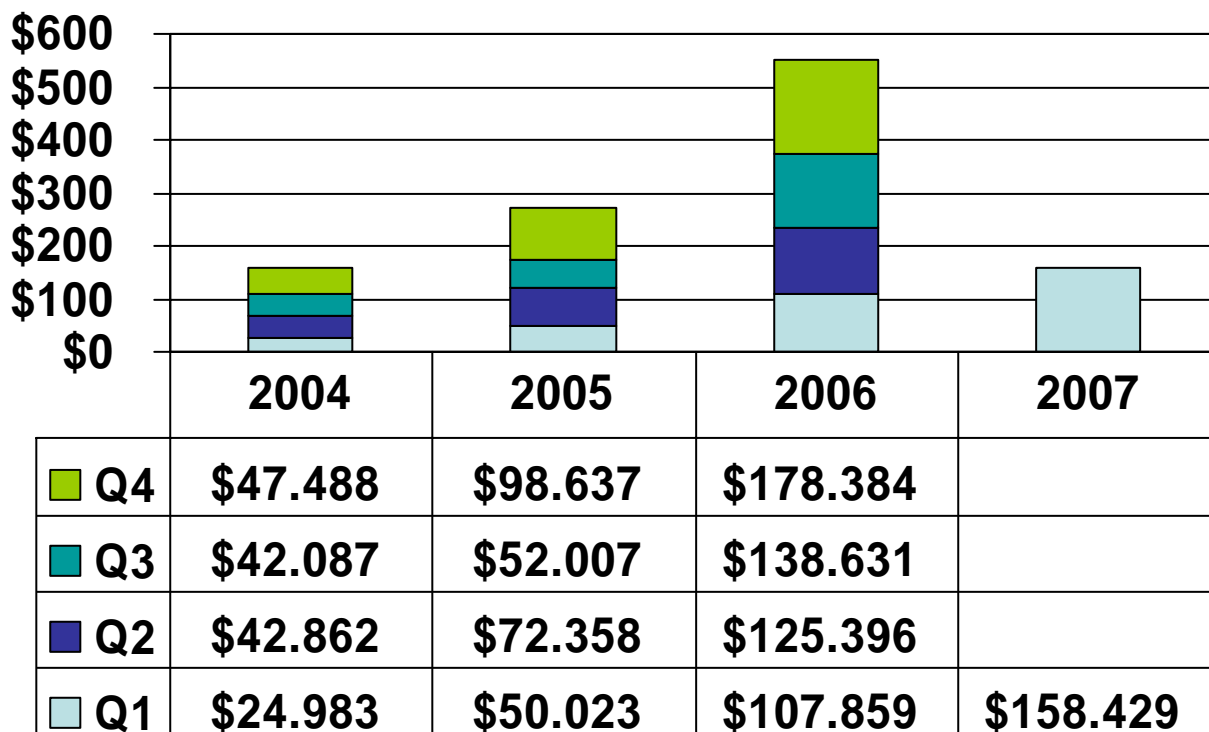
Before continuing the saga, please oblige us a sidebar regarding the packaging of fixed income instruments by Wall Street. Wall Street loves to package things. These efforts are referred to in the trade as “structured finance.” We tend to refer to such as “black boxes,” given that it is very complex (if not impossible) to look inside and determine the value of such an instrument under various interest rate and credit market scenarios. This propensity to package underlying assets into a single security hit its stride in the late ‘80s and early ‘90s with collateralized mortgage obligations (CMOs). CMOs contain mortgage backed securities (MBSs). The cash flows from the MBSs are stratified into groups, or tranches, each having a different schedule or priority of receiving the cash flows. In the bear market for bonds in ‘94, CMOs became highly illiquid and any investor feeling pressure to sell suffered a very large haircut to get out. The current decade has seen explosive growth (see chart on next page) in an instrument broadly referred to as a collateralized debt obligation (CDO). These instruments can contain a whole host of assets such as mortgages, mortgage backed securities, bank loans or corporate bonds (they can contain even more esoteric asset types than these, but we’ll stop right there before you swear off ever reading this again). CDOs differ from CMOs in that instead of tranching the cash flows as in CMOs, CDOs are structured with credit default tranching whereby investors in one group suffer the default losses within the portfolio before the next group. Due to the complexity and lack of secondary market trading in these securities, pricing has mainly been left up to the investor (read hedge fund manager) modeling a price based on various assumptions, not from actual trades (more on the pricing of esoteric and illiquid investments later). The attractiveness of CDOs on the buy side has been the high level of diversification within each instrument. We believe many investors in CDOs and the bond rating agencies have taken too much comfort in this high level of diversification and have used this to take the place of proper credit and security analysis.



Now back to the story that had you on the edge of your seat in the first place. Sub-prime mortgages, a profitable niche business for some financial institutions prior to the current decade, were a natural asset to put into a CDO structure. With Wall Street firms in the picture marketing these CDOs to investors, the availability of credit for sub-prime borrowers mushroomed. Mortgage brokers across the country took note of this, and generated the quantity of sub-prime loans the market was demanding. You would not be shocked to know that sometimes these loans were originated with an eye on collecting the transaction fee, not on providing true documentation and a reasonably creditworthy borrower.

CDO Market Issuance Data

(in billions)



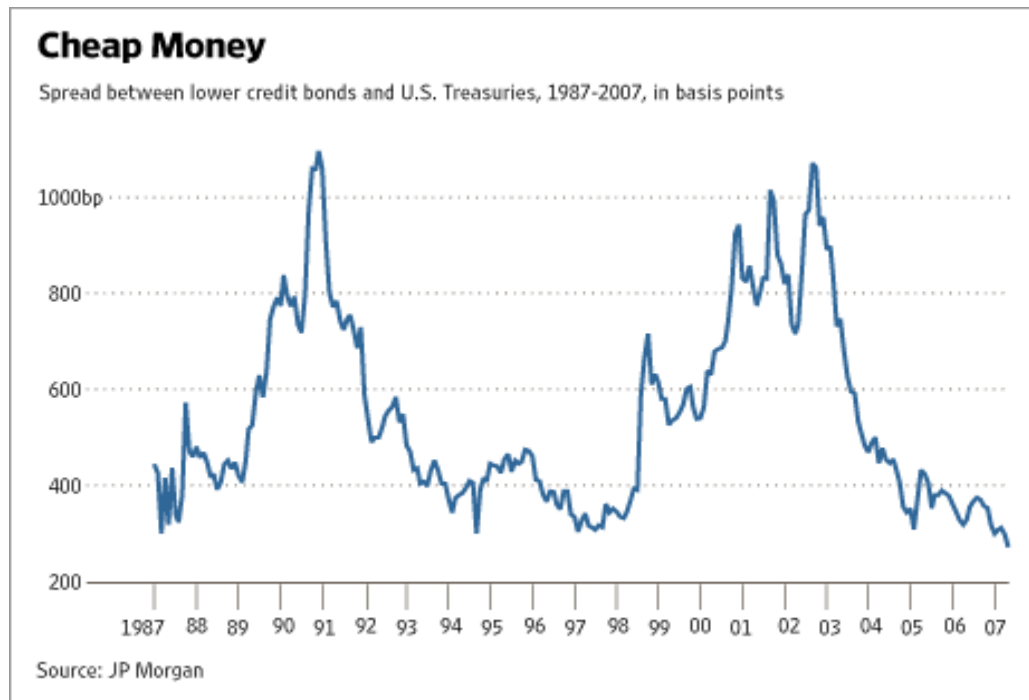
Source: Securities Industry and Financial Markets Association

Some of these sub-prime borrowers could not even make the first mortgage payment. As default experience on these instruments has risen, the underlying collateral has eroded in value. This has been going on for about eighteen months, as default rates have been on the rise. You would have

never suspected trouble by looking at the pricing of CDOs containing sub-prime mortgages. The hedge fund managers, using their fancy pricing models, were apparently pricing these things near par. As long as a big volume of these securities did not have to trade in the secondary market, there was no trade data to substantiate the marking down of their prices. Everyone, including the hedge funds that had been collecting large performance fees based on hypothetical prices, was happy...until recently.

You may have read where two large hedge funds managed and marketed by Bear Stearns and specializing in this type of investment has had issues. As mortgage default rates on sub-prime mortgages continued to climb, the lenders (particularly Merrill Lynch) that provided the leverage for the funds began to get nervous. Merrill pushed for a forced auction of their underlying collateral. According to *The Wall Street Journal*, the funds controlled more than \$20 billion of sub-prime mortgages, at least \$9 billion of which was borrowed. Wall Street held its breath, knowing that a public auction would reveal that, surprise, these things were not worth par after all. The Street fears that problems in these particular investments could bring increased scrutiny of all CDOs. Remember that the hedge funds have been Wall Street's biggest revenue producer in the last few years, and the last thing they want to do is harm this relationship. Anyway, Bear Stearns stepped in and provided loans (essentially answering a margin call) to prevent a forced sale by Merrill. It remains to be seen how investors in similar hedge fund strategies will react. As we write this, two British hedge funds investing in sub-prime CDOs have shut down and, according to *The Wall Street Journal*, one suffered losses of 53%. No doubt the losses were accelerated by a leveraged position.

All of this carnage in sub-prime loans is just beginning to affect other markets. As you can see from the previous chart, CDO issuance continued to grow at a rapid 46.9% rate during the first quarter of the year. Reports indicate that new CDOs of all types are suddenly less popular and are not being met with the flood of cash they once were. Do you remember we said that CDOs can also contain corporate bonds and bank loans? Liquidity is starting to dry up in those markets as well. While we have only noticed the smallest increase in low grade corporate bond spreads over U.S. Treasury notes thus far, we are closely watching this spread as an indication that risk tolerances have moved. They have recently been at an all-time low (see chart on next page). Several bank and Wall Street financings have just been put on hold due to the change in credit markets, and this will impact the private equity boom going forward.



Hopefully you are getting a sense of how much credit has been thrown at borrowers, particularly “alternative investments” in hedge funds and private equity funds. So many private equity deals now contain high levels of debt financing that we are beginning to hear them referred to as “leveraged buyout funds,” that moniker from yesteryear. All of this borrowed money is in addition to the huge flow of equity capital being funneled to alternative investments by “sophisticated” investors. Much alternative investing is being done in the name of diversification. We often refer to this as Modern Portfolio Theory run amok. Most consultants employ Modern Portfolio Theory in making asset allocation decisions. The linchpin of Modern Portfolio Theory is that risk can be quantified (we don’t believe it), namely that standard deviation of return defines risk (ditto). The line of thought is that if an asset class has historical returns that have a low degree of correlation with other classes, then it should be added to a portfolio to some degree. It is revealing that alternative investments did not become the rage until a handful of investors using their own capital and also investing for Yale, Harvard and a few other large pools produced huge returns between 2000 and 2002, three negative years for the stock market. Suddenly, diversification became much more important.

This brings us to the equity markets. It has been fascinating to us to see money pushed to the private equity pools by investors believing they were getting an alternative asset, only to have that money funneled back into buying public companies at high valuations. It has not helped to cure us of our cynicism that at the same time this was going on, two of the largest private equity funds were taking their own stock public, with others planning to follow. Talk about your inconsistencies! Are we the only ones that find it questionable that at the same time private equity funds are using investor money to take public companies private they are cashing out by selling their own stock in the public market? Whose interests are **really** being represented?

We suspect that there is also some smoke and mirrors involved in the ongoing pricing of private equity assets, and thus reported returns. We also believe that high prices for their acquisitions are being paid with the assumption that they will monetize the investments in the pool by selling at equally high valuations down the road, or by taking the companies public again, as they have done with Hertz and Burger King. The private equity and public stock markets may not be so generous when that time comes.

If credit for financing private equity acquisitions and corporate mergers becomes less available, valuations in the stock market should come down. It is hard to envision that the cost of margin buying would not also rise, putting further pressure on stock prices. We are well prepared if that happens.