

## How the Correction Turned Into a Bear Market, and Other Events October 2, 2008

### Introduction

Before getting into the meat of this email, we apologize for its length. But there is a lot to cover. Secondly, during this extraordinarily volatile period, we want you to know we are very deeply and fundamentally concerned about you and all our clients. You count on us for your long-term financial security, and we take that responsibility extremely seriously. You've been about accumulating your assets all your life. We've been in our business for decades, helping people through good times and bad and through times we've been more right and times we've been more wrong. We take this responsibility very seriously and feel for you when things don't work well in the short-term.

Please know our evaluation of the current situation isn't based on some Pollyanna view of how the investment world functions. We have worked very hard to understand what's happening in this period and to give you the best possible advice about what to do under the circumstances. We think we have some conclusions and observations below that you won't have heard elsewhere yet, some with startling and almost un-American-feeling conclusions that we wish were different than they are. And, make no mistake, a lot has happened in the last month to add color and let us see some things that started in the late spring that seem to us to be totally unnoticed, in public at least.

And, yes, again, we very much acknowledge having been wrong. We want you to see what we think we missed and why. While many say anyone could have seen all this coming just by reading the newspapers, the actual features making our earlier views go haywire are ones that started in May and have been largely or totally un-discussed.

Yes, some people were bearish coming into this year, but most weren't, which isn't unusual early in a bear market. And those that were are mostly variations of what we see as perma-bears. But we certainly were bullish and got this period wrong. Of course we weren't alone. The chief strategists at the major brokerage houses and money management firms we compete with were also not bearish. That is no solace to you. The real issue is: what did we and most others miss when the 2007 narrative (sub-prime mortgage morphing into a housing downturn morphing into a US recession morphing into a global recession) was old, exceptionally well known, and had been heavily studied by us and others—and hadn't happened for over a year? We will address that below, but we also want to address some other points of particular concern including:

- Will you consider reducing your advisory fees?
- What led to the financial panic?
- Are Paulson and Bernanke heroes or villains?
- What went wrong in Fisher's forecasting?
- What lessons has Fisher learned?

- What is your portfolio strategy to recoup losses?
- Is the \$700 billion government rescue plan advisable?
- What else could or should the government do now?
- What is your current view on the economy?
- What else should we be thinking about?

In this communication we aren't going to tell you about all the reasons you should be focusing on the long-term. We also aren't going to say that if you have a long time horizon this event won't materially alter the chances of reaching your goals. We have said those things plenty before and you're familiar with them. If for any reason you feel you're not, contact your investment counselor who will be more than happy to take you back through them.

We know there is a strong urge at times like this to throw in the towel and rush to a safe haven. This always happens near market bottoms. But we do know that bull markets follow bear markets and that in each previous case, investors should have been buying or holding, not selling. If you tire of hearing that from us then you tire of the simple truth. Bull markets do follow bear markets, and the downside of the end of bear markets is very small compared to the initial up-thrust of the next subsequent bull market.

Many say anyone can see from here that stocks are headed lower. Look at all the bad news. Well, we're 100% certain that the time when the most will be most certain stocks are headed lower is just after the final bottom, whenever that is. We can't say for sure if the absolute bottom has been reached now or if there won't be elevated volatility going forward. Our guess would be that after the bottom, whenever it is, stocks will remain volatile, choppy, and scary as the dickens as they go higher, trying to buck as many people as possible off the market as it rises.

We also do know this: there are solutions to the financial panic that has taken the world by storm. The banking system and broad economy can withstand this onslaught. And as that becomes clearer, owning stocks should prove extraordinarily rewarding eventually. We strongly advise keeping our previously recommended allocation to stocks and categories to best recoup recent losses. Most categories getting hurt more than the market late in bear market bottoms usually bounce back more. That we have been lagging just lately as the market has panicked suggests the same general sector and country allocations should lead the way out the other side.

If, after due consideration, you feel you need to move some portion of your assets to the sidelines, we understand and will cooperate to make that happen, although it's definitely against our best advice for you to do so. Regardless of what action you take, please understand we are working hard for you. Together, we will work through these difficult times.

### **Will you consider reducing your advisory fees?**

Some clients have suggested we cut or refund advisory fees because of the downturn in portfolios, as in, "I'm not making any money so why should you be?" You may have had similar thoughts yourself. But the answer is, and we want you to think this through fully: we won't and

really can't effectively. Think through the implications of acting on this suggestion. First, know, and you may not have thought about this, that we aren't making any money. Our advisory fees are essentially our sole source of revenue. They are based on a fixed fee charged against the variable market value of your portfolio. As your portfolio has shrunk in value, our revenue has declined proportionately. So our revenue has fallen as a result of falling portfolio values. At the same time our costs are mainly fixed, so we are currently losing money and have been for some time now. While we have no debt and are perfectly solvent, to address this, because we can't allow it to continue, we have taken steps to reduce various discretionary costs so that we won't continue losing money. We're very used to this. We really don't have any choice. This includes, for example, suspending much of our advertising including all our TV, radio and print advertising (you may see some for a while longer due to the long lead-time nature of buying some mediums in advance—things we've already paid for and can't stop). We've cut a variety of parallel discretionary items aimed at growth since we aren't growing now. But cutting actual fee rates or refunding fees would necessitate reducing headcount markedly, which would reduce capacity and capabilities that directly work for you, such as your investment counselor and all the services that support him or her; our research group which is basic to knowing what to do; trading; etc. And we won't do that.

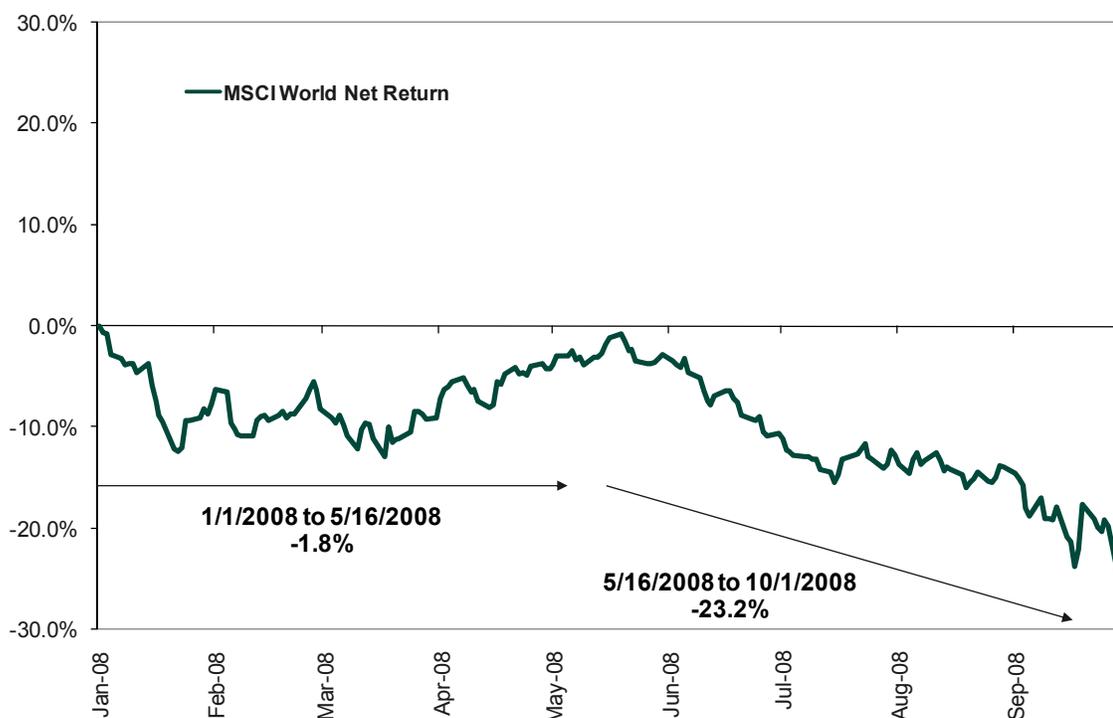
While you may not think of it, our fee structure was originally designed to align our interests with your interests over time. As your asset values go up, so does the fee you pay. As your asset values fall, so does the fee you pay. Just so, as your asset values rise, so does our revenue. And as your asset values fall, so does our revenue. That's where we find ourselves now. That's also why we have always had every incentive to sidestep bear markets for you—we have no incentive to do otherwise. We just didn't see it right this time.

In the good times and if we do everything right we plow profits back into growing the firm which is how we've grown the firm over the years--but in the bad times and if we don't do everything right, we go the other way, cut costs, eliminate growth expenditures and shrink down to the bone and muscle. That's what we're doing now. We've lived with that for decades. That hasn't ever changed. None of our clients were asking to pay us a higher fee rate in a good time like last year or the year before. We don't cut them in the bad times either. Over time it all averages out. So, again, we effectively can't reduce fee rates or offer refunds because we can't cut the services necessary to the basic function you've hired us for. Some say, "Why not have Ken pay for it; he's rich". But the basis of Ken's net worth is the firm which has just taken a gargantuan haircut, just like everyone else. Note, Ken previously had a total salary of \$250,000 and that has been eliminated. Simply said, we already have every incentive to do well for you and no other incentive. Our interests are almost perfectly aligned with yours. We are all in this together. And hence we do very much sympathize with what you're going through. That merits repeating: Our interests are aligned with yours and we're very sympathetic to what you're going through and your emotions in reaction to the market because they impact us as well. Now, let's see how we got here.

## What led to the financial panic?

Several things are very clear. To begin, it is critical to note that the stock market was basically flat for the year through mid-May. Despite having lows in late January and March it had recovered markedly by May. On May 19th, the MSCI World was down 1.8% for the year and 7.2% since the November peak. The S&P 500 was down 2.8% for the year then and 8.9% since the peak. And while you may not know this and may not care now, through that period we were beating either the World market or the S&P 500 fairly well. All the material damage has been since then on both an absolute and relative basis. So what has happened in and around that time period and since that drove the market down?

## MSCI World Net Return 1/1/2008 through 10/1/2008



Source: Thomson Financial Datastream

Furthermore, as you look at the above chart you can see that almost exactly half of the decline since May happened in September, a whopping month as panic ensnared everything and turned what had been a big correction by normal standards into a full scale bear market by any standards. So we have to think of September alone, too.

In our view two converging forces turned what should have been a correction within a normal bull market—instead--into a financial sector panic that caused the bear market. The first force was the effect of accounting rule changes that made leveraged financial institutions vulnerable to

rapid decreases in the value of illiquid assets. That happened earlier and set the stage. The second and later force was the government's deliberate dismantling of Wall Street as we have known it, done in the name of saving things, but instead causing massive dislocations. We didn't foresee this second step, didn't understand it as it was unfolding, and until two weeks ago couldn't put together the clues we will show you. If you had said to us two or three months ago that what we're about to describe could or would be done, we would have been incredulous. But it did. We will explain further below. First, we start with the initial force, which requires some explanation but is more explicable than the second force.

### *Fair Value and Mark-to-Market Accounting*

From 1975 to 2004, the Securities and Exchange Commission used Rule 15c3-1 (the "Net Capital Rule") as a primary tool to ensure broker-dealers had adequate capital and sufficient liquidity. This rule mandated broker-dealers compute daily capital ratios using current market prices minus a "haircut" on assets to account for market volatility. The rule also limited total debt to 12 times net capital. In 2004, attempting to keep up with European regulation, the SEC offered an alternative approach. It allowed broker-dealers a method to avoid asset haircuts and also increase leverage. This only affected the biggest Wall Street firms, those with greater than \$5 billion of capital. These firms took full advantage, and by 2007 many had increased leverage ratios to greater than 30 times net capital. At the time, and many forget this, the government was actively encouraging financial institutions to take on more risk to make lower quality loans for purposes like home mortgages to lower income borrowing. You may remember all the government concern about issues like "red-lining".

In the process of increasing leverage for whatever reasons, many Wall Street firms bought and held increasingly complex securities, including mortgage-backed, collateralized debt obligations, and credit default swaps—all of which share the common trait of being difficult to value because they trade in illiquid or opaque markets.

In early November 2007, almost perfectly at the peak of the bull market, a new rule took effect that tragically altered how these securities would be valued. FASB Rule 157, which had its roots in the awful Sarbanes-Oxley Act of 2002, dictated that even illiquid assets such as these esoteric securities would be valued using a "Mark-to-Market" technique. This means that even if an asset was intended to be held on the balance sheet until maturity, the current implied market value would have to be reflected. Because these are non-public securities with no market pricing applying a current market value was often guesswork since many of the securities rarely traded if at all.

The basic premise of a bank is to exchange short-term, liquid, easy to value liabilities for long-term, illiquid assets whose value is hard to gauge. This has been true forever. This liquidity and maturity trade-off is the main social function banking systems provide. Suddenly with FASB 157, a financial institution's solvency was determined by its theoretical ability to liquidate its entire asset base overnight to pay off all its liabilities. By this new standard, almost every bank in the history of the world would be insolvent. This is a little like if you bought a large piece of

raw land, which is notoriously illiquid, but then had to carry it on your books as if you had to sell it for cash in a week. It would always be below what you paid for it. No other part of accounting works like this.

The basics of accounting rules are set by America's Financial Accounting Standards Board (FASB) and the London-based International Standards Accounting Board (IASB). In April, the banking industry lobbying group IIF sent a memo to both standards boards asking to suspend the current mark-to-market rules because they were causing unintended consequences for sound assets that were hard to value yet were forced into write-downs.

Both bodies and American regulators remained silent. In the early months of the bear market, this new accounting rule made financial institutions susceptible if the markets for their illiquid, non-publically traded holdings experienced increased visible volatility.

How could that happen? One firm openly writes the assets down markedly because it thinks it should. And it can afford it. But that requires another firm that is less sound to write down similar assets, and maybe this institution, bank or investment bank, can't afford it and goes under. In the process the securities it owned get sold in a fire sale—and, of course, at still lower prices, which then establishes a new lower level for others to have to write down their assets to. This is the negative feedback loop we have seen of late. Publicly visible write downs at one firm causing write downs at another firm, leading to fire sales which cause everyone to write down assets still further. It is the inherent dilemma of having to mark balance sheet assets down to implied market values in a world where there is no continuous market for the assets. Bear Stearns was an early casualty—the market for asset backed securities declined, and Bear Stearns was forced to mark down its assets severely because of the new accounting rules. It quickly met its demise in March 2008.

This is basically the first force mentioned above. It was caused by sequential changes to government and quasi-government rules and could be easily eliminated by Congress passing a bill creating a permanent, or maybe even temporary, holiday on Fair Value and Mark-to-Market accounting requirements. Now to the second force:

### *The Dismantling of Wall Street as We Know It*

If you had told us even a very short time ago that all five of Wall Street's leading independent investment banks would in a month disappear in one way or another as independent entities operating in the structure they've operated in for fully 75 years--we would have said that was unbelievable. But that's what happened. We were observing the same things everyone else was as Bear Stearns and then Freddie Mac and Fannie Mae and Lehman imploded. But when the AIG nationalization happened on the others' heels we stopped and asked ourselves, how do you get the same minds working on these various deals to justify the differing structures in each of them. What unifies the deals? Why are they being handled so differently? What could possibly be in the minds of Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke to construct these deals as they did?

Well, we still speculate about a lot of things they may have been thinking, since we can't really get in their minds, but we can say that the thing that hangs the deals together is that they all, one after another, subordinate non-bank financial services interests to banking interests regulated by the Federal Reserve. In the process, deal after deal protected the banking sector's interests at the expense of non-bank financial services interests. Let us explain.

At first, in March, it seemed the government intervened to help calm nervous markets when Bear Stearns, a major investment bank, failed. In retrospect it looks less benign.

Consider some simple facts. Bernanke and Paulson arranged for JP Morgan (a commercial bank) to buy Bear Stearns. But on the Friday before the deal Bear Stearns' stock closed at \$30. Over the weekend they negotiated a deal, announced on Sunday night, starting a new pattern of Bernanke/Paulson weekend deals, and JP Morgan was to buy Bear Stearns at \$2 per share with a government guarantee. On Monday the market opened above \$2, refused to sink that low, and traded as high as \$8.50 over the course of the week. Ultimately JP Morgan agreed to the deal as it was but at \$10 instead of \$2 as public shareholders refused the lower price. That tells you the deal carved by Bernanke and Paulson was too sweet to JP Morgan by \$8 per share. That was the first example of Bernanke and Paulson doing a deal that subjugated non-bank financial services interests to bank interests. As we describe further it turns untoward from here and gets worse, but to summarize what we will be telling you, Bernanke and Paulson set out to quickly reshape, maybe re-engineer, the entire scope of investment banking—reversing most of what was first implemented 75 years ago with the passage of the Glass-Steagall Act of 1933.

Why did Bernanke and Paulson step in to do what they did in relation to Bear Stearns? Well, again, we can't be inside their heads, but we're confident it was because the counterparty risk to a Bear Stearns bankruptcy would cause losses to banks broadly, and they wanted to protect the banking system's solvency. Their subsequent actions demonstrate that when banks are set to suffer, they provide protection to banking. If banks aren't to suffer, they are content to simply let the institution fail, as we will see with Lehman Brothers.

While people who feared a crisis from Bear Stearns' failure felt a crisis was averted by the JP Morgan acquisition and the media portrayed Bernanke and Paulson as saviors, the underlying nature of force one, as described above, continued.

The Mark-to-Market rule adversely affected many other financial institutions of varying forms: banks, investment banks, insurance firms and more. The continued weakness of the residential real estate market caused increased mortgage defaults, and the market for mortgage-related securities dried up. That was to be expected. Hundreds of billions of dollars of assets were written down. That was to be expected. This pushed Fannie Mae and Freddie Mac to the brink. That was to be expected. But what Bernanke and Paulson would do wasn't expected. They nationalized the two quasi-government entities. Again, shareholders were wiped out, but bondholders were saved. And, again, those who would suffer in Fannie and Freddie failed, those

on the other side of counter-party risk from them, were primarily banks. Bernanke and Paulson didn't want that failure.

An important side note happened in July. Merrill Lynch sold \$31 billion of collateralized debt obligations it owned for 22 cents on the dollar to Lone Star, a Dallas based private equity firm. The transaction was highly publicized. John Thane, Merrill's CEO, proclaimed the price was less than they were worth but that it was in Merrill's best interest to get the assets off their books and put behind them. Problematically, that price set a new low standard for how similar securities should be marked to market at other firms, and another set of write downs across firms were initiated.

From the process of write downs Lehman Brothers, another investment bank, came under duress. But by then, private institutional investors had seen Bernanke and Paulson repeatedly wipe out shareholders of other distressed financial companies and were deterred from injecting capital, whether equity or debt, into troubled Lehman. This time the government decided it didn't need to save either Lehman's shareholders or bondholders. So, they simply let Lehman go bankrupt. After all, Lehman was not a commercial bank, so it wasn't Bernanke's responsibility. And unlike Fannie and Freddie, its debt wasn't a major holding of the commercial banking system. (Actually, lowly municipalities were among the biggest losers in Lehman's bankruptcy.)

Now a reasonable but never brought up question is whether Bernanke and Paulson *let* Lehman fail or effectively *caused* its bankruptcy. Since every possible institutional investor of size could see Bernanke and Paulson circling over Lehman, they knew these two could do whatever they wanted, and they had seen the wipe-out of Bear Stearns and Freddie and Fannie's equity. So none were willing not only to inject equity capital but even lend short-term money. All banks and investment banks regularly borrow short-term money from other financial institutions. It's a normal part of the business. But now, if the government signals it may force a restructuring of that institution, no one will want to lend money for fear of suffering the consequences of Bernanke and Paulson's actions. If no one will lend to renew prior borrowings, any bank, investment bank or insurance company will go bankrupt. Any!

On Friday September 12<sup>th</sup>, Paulson, Bernanke and New York Fed President Timothy Geithner convened the leading names of finance in Manhattan at Geithner's office to address the financial crisis and discuss the possible bailout of Lehman. One of the parties to that meeting was a team of senior officers of British-based Barclays Bank, which had been in negotiations to invest money into Lehman, including possibly a total buyout. They ultimately concluded against it. Instead, Barclays is now picking Lehman's bones at cheaper prices in bankruptcy, buying its M&A business and midtown Manhattan headquarters. Barclays wasn't alone. Since everyone knew the Fed would be meeting with Lehman over the weekend, no one would lend them money to renew their prior loans. If no one would lend them money and the government wouldn't bail them out, bankruptcy was unavoidable. On Monday the 15<sup>th</sup>, just three days after that meeting, Lehman filed bankruptcy because no one would lend them money. Very simple!

Think of it this way. If someone wanted to borrow money from you and you knew powerful guys were likely to come in and restructure everything in that firm in some unpredictable way that could be untoward to your interests, would you lend them money? Of course not!

Chaos ensued in many unexpected corners. Regardless of who held the Lehman's counterparty risk, the nature of a bankruptcy means a fire sale, implying more write-downs. Who could be hurt most by more write-downs? Who would Bernanke and Paulson circle next? Who, therefore, wouldn't the private sector lend to next and hence be killed. Insurance giant AIG was one such place. It had written huge amounts of credit defaults swaps (although tiny compared to AIG's total size), including some on Lehman debt. (Credit default swaps are private contracts that allow buyers insurance protection on bonds in the event of their default.) The CDS market spiked in reaction to Lehman, the world's biggest bankruptcy, and AIG was forced to post tens of billions of dollars collateral to cover its rapidly rising obligations. Now remember AIG had over \$100 billion of annual revenue and was otherwise profitable but had borrowings. Once again, Bernanke and Paulson descended and wiped out shareholders by effectively nationalizing AIG. Why nationalize this one, for the same reason it did with Freddie and Fannie. The counter party risk was primarily to the banking system, which is Bernanke's primary turf to protect.

While all this was happening, Merrill Lynch slyly sold itself to Bank of America. If it had not, it likely would have met the same fate as Lehman. It, like all its peers, had overnight borrowings. People would have seen it as next to be circled by Bernanke and Paulson and next to stop lending to. One week later, Goldman Sachs and Morgan Stanley, the last two independent Wall Street investment banks of any size, petitioned the Fed to become federally chartered banks, submitting themselves to Bernanke's domain. They desired to join the protected class. At that very moment, the government had vaporized Wall Street, as we've known it, all in the course of a few short months.

The government has not been the solution to the financial crisis—in our eyes it has been the cause. By telegraphing not to lend to certain companies, the government doomed their fates. And in the process, Bernanke and Paulson decided who among the survivors would get the spoils. Their actions precipitated the very panic they sought to avoid as they reengineered investment banking back inside commercial banking to a pre Glass-Steagall condition. One of the great ironies of this period is that in the aftermath of the 1929-32 debacle one of the lessons society thought it learned was that investment banking had to be separated by law from commercial banking (the heart of Glass-Steagall). Now, in this period, the lesson society is concluding, or at least that Bernanke and Paulson have engineered, is to recombine investment banking back underneath commercial banking and reverse the original intent of Glass-Steagall almost completely.

### **Are Paulson and Bernanke heroes or villains?**

In modern times Treasury Secretaries have never wielded such massive power nor done such enormous damage as Henry Paulson. And all of it has occurred at the lame duck, very tail end of his term in office. Normally, Treasury Secretaries aren't very important in the grand scheme of

life. How many of them can you even remember? Think quick! Most were largely symbolic. Few accomplished anything very noteworthy. They oversaw the funding of the government, and that's about it. They made public statements, almost always benign.

Probably the most noteworthy of recent decades was Nicholas Brady, who under George H.W. Bush created so-called Brady bonds in 1989 to deal with various Latin American sovereign debt defaults and was Treasury Secretary at the time the Resolution Trust Corporation was created (although he wasn't central to its creation or management). Think of who else in your lifetime as Treasury Secretary has made a big mark on the world. I bet you can't think of anyone. James Baker? Lloyd Bentsen? David Kennedy? Who was David Kennedy? That's our point. G. William Miller? Not a chance. So what Paulson has done becomes all the more remarkable. In the early 1990s, the Savings & Loan Crisis went away in an orderly basis as almost two thousand banks and thrifts either failed or were merged into stronger entities.

But in this crisis, the biggest investment banks have been exterminated, taken over by banks, or compelled to become banks in a disorderly, rushed fashion. Now, we're not crying for investment banks or feeling sorry for them. But they have a function and place in our world and we want you to see the difficulty of envisioning such a rapid-fire reorganization of America's complex financial system without material dislocations. We have just witnessed such a scene. Most amazingly, the Lehman bankruptcy, which now feels like old news, was less than three weeks ago. It's amazing so much has happened so fast.

Paulson is widely portrayed in the media as today's chief rescuer. But from our view he is the chief executioner in what has become a very unpleasant reengineering of America's financial system.

Paulson left as CEO of Goldman Sachs in July 2006. Just two years later, he and Bernanke have overseen a process forcing all of Goldman's primary independent investment banking competitors to go bankrupt or flee to the protection of a bank. The process has not only entrenched Goldman as the largest pure-play investment bank (although technically a newly chartered bank holding company), but it has gained market share from all the reengineering.

This is scandalous at best, yet amazingly almost no one speaks of it. Former Speaker of the House Newt Gingrich is one of the few to have recognized and spoken about this and concluded how appalling it is that President Bush hasn't fired Paulson. Gingrich specifically notes the meetings to nationalize AIG, where Paulson allowed current Goldman Sachs CEO, Lloyd Blankfein, to sit in and participate in deciding the fate of the behemoth insurer. Blankfein supposedly was invited as a party interested in the public good. But Goldman Sachs had huge amounts at stake—reportedly some \$20 billion of counterparty risk tied to the outcome of AIG. Blankfein was also the only private sector corporate officer to sit in on these meetings. Why only him? In most circumstances that conflict of interest alone, orchestrated by Paulson, would generate choruses screaming for Paulson's head. In this environment no one noticed. Everyone focused instead on Paulson's shrill demand that we need a bailout and that things are so fragile.

We're not suggesting Paulson did any of this with some intent to personally profit off it by Goldman prospering at the expense of other investment banks. We don't believe he has a personal profit axe to grind at all. But all his life at Goldman he would have adopted certain biases and considered Goldman great--and looked at his competitors with disdain. Goldman steadily climbed up the ranks of investment banking from a top tier specialty firm in the 1960s to eventually become the premier investment bank. With that comes condescension and hostility toward your lesser competitors. In 1965 Merrill Lynch was the top investment bank in pretty much every category. By 2005 Paulson would look at Merrill as if he had pretty much conquered them. Bear Stearns? Lehman? His view, in our estimation, would be that they are lesser entities and much like had long ago happened with Smith Barney, maybe better run by a bank, leaving free-wheeling independentness to a truly great firm like Goldman that could handle the risks. It's not conflict of interest as much as it is natural bias built over a career from looking at things from Goldman's viewpoint.

Consider what Paulson told the directors of Fannie Mae and Freddie Mac as he nationalized them. "My role in these meetings was always to say, 'This is going to happen.' This is about the United States of America, our capital markets, your company. Be part of the solution. It won't be good for anyone if you don't consent. I need to know this evening. Your lawyers can spend a lot of time—then we won't get there, and then it will be involuntary." That's scary.

How would you like it if someone powerful from the government arrived at your office and talked to you that way? Told you to do what they wanted, or else? We're supposed to have better property rights to protect us from the government here in America than that. That sounds like Venezuela.

In July, Paulson argued before Congress in favor of a formal mechanism to take over and wind down the non-banks (including investment banks and many insurers) in an orderly way and spoke of the banking system as the better model. We should have noticed that and did. But Congress ignored him at the time, and so we felt there weren't any legs there. Little did we suspect that he and Bernanke would simply go do it on their own without Congress. We missed that completely. So did everyone else.

On Capitol Hill this summer Paulson said, "If you've got a bazooka, and people know you've got it, you may not have to take it out." He has been able to re-sculpt the landscape without having to ever actually pull the trigger directly on the investment banks. As to shareholders in the process, he said, "When there is intervention, I really believe the shareholders need to lose." And they have.

Note he later avoided intervention in the takeover of Merrill Lynch by Bank of America so Merrill's shareholders wouldn't lose. Why? Every other major financial institution takeover this year by any one of the big three banks (Bank of America, Citi, and JP Morgan) was directly orchestrated by the government. This one is the exception. Why? We don't definitively know why. Knowing is different than suspecting. And again, we can't get inside these men's heads. Ironically, though, Merrill's chief John Thain was Paulson's former second-in-command at

Goldman Sachs. It's almost as if they planned this together. Of course, we don't really know that. But the threads around Paulson and conflict of interest and personal relationships in the last month are mindboggling, and almost no one speaks of them which we find even more mindboggling. How has he gotten away with this?

Among large investment banks, only Goldman Sachs and Morgan Stanley avoided bankruptcy or takeover. And then both amazingly converted to bank holding company status the same Sunday in a deal with Bernanke and Paulson and were allowed to remain independent. That puts them both squarely in Bernanke's turf and the realm he has steadily moved to protect. And then, after that, both got very similar equity injections from significant outside interests, almost as if it had been planned that way, together.

You might ask why Morgan Stanley is still standing if Goldman was positioned to eliminate all its competition. Well, again, we're not really sure that was a plan and not just how Paulson ended up doing things. But, regardless, it is true that Morgan's salvation provides plausible deniability to any accusations of a Goldman conspiracy or wrongdoing by Paulson that benefits solely Goldman. We wonder if Paulson thought of that. We know all this sounds scandalous, but it is impossible to find a modern Treasury Secretary who has acted even partially the way Paulson has—either in scope or in how much his actions have helped the Treasury Secretary's former firm's relative position in the world.

Paulson's fingerprints are all over this. But so are Goldman's. Note that Paulson personally asked AIG former CEO Robert Willumstad to step aside in favor of Paulson's handpicked Edward Liddy, former boss of Allstate. That's fine. But note that Liddy was also a member of the Goldman Sachs board of directors. Why does so much of everything point back to Goldman?

Then step back first for a moment. Paulson has proposed the biggest government buyout of private interests in American history, originally submitted to Congress as a three page proposal with no restrictions, no oversight of what or how it would happen, no restriction as to pricing, and no recourse against the Treasury under any circumstance. That by itself seems almost unbelievable—a former investment bank CEO at the helm when most Americans don't trust investment bankers any too much, anyway. Yet Goldman Sachs has exactly the kind of instruments Paulson proposes buying. The seeming conflict here is too much, particularly after all of the other Goldman connections. We think it's strange no one speaks of this.

### **Where does Bernanke fit into all of this and why does he go along?**

Usually, Federal Reserve chairs are politely condescending toward Treasury Secretaries. Fed Chairs have been appointed in the fourth year of President's terms to serve the next four years for the next President, whoever that maybe, whether the President is seeking reelection or not. It was originally set up this way so the Fed Chair would be more insulated from the daily forces of politics. The Federal Reserve, in theory, is independent of the current administration. Treasury Secretaries by comparison are purely political animals. They are appointed and sit at the

pleasure of the President who could ask for the Treasury Secretary's resignation any day of the week, 24x7.

Hence they are normally lesser creatures in financial importance and power than Fed Chairmen. Nixon, Reagan, Clinton and George W. Bush each by chance had three of them, whereas Henry Morgenthau, Jr. served both Franklin Roosevelt and Harry Truman for 11 and a half years. Presidents can do whatever they want with Treasury Secretaries—keep them or spit them out at a moments notice—and hence they have historically been lesser players than Fed Chairs.

But Bernanke has acted in almost total partnership with Paulson, has not taken many of the steps we detail later in this email that he could take, already fully within his power, that could alleviate current conditions—and you have to wonder why? In most ways he has actually let Paulson lead their partnership as if he were the subordinate. Why?

Well we don't really know. We only suspect, and we're sure you're not going to like what we suspect. First and beyond dispute is that all of these actions taken this year and particularly since May extend the turf and protect the turf that is under the Federal Reserve's control and regulation. And so in that way you can see his actions as participatory in cooperation with Paulson of simply extending and protecting his turf. The banks are his to regulate and problems in banks are black marks against him, though he came along very late in the game that created things like collateralized debt obligations and credit derivative swaps. And the many actions taken which subjugated non-bank financial services interests to bank interests—like the Bear Stearns and Merrill Lynch deals or the chartering of Goldman Sachs and Morgan Stanley as bank holding companies—that all extended his turf. So that part makes sense in terms of his motive.

But why so cozy and supportive of Paulson in all things and why give him the leadership position? We have always said that Fed Chairs aren't supposed to be political, but they are, and they work very hard to get re-appointed. (We refer you back to our prior writings on this. Your investment counselor can take you through it if you wish.) But for Bernanke this must be particularly true. He came to office tied to the unusual circumstances of terms limits that had been imposed by Congress on Alan Greenspan. Bernanke has lived out these past years the butt stub of Alan Greenspan's term. And the nature of that Congressional act, as we've written before, changes the timing of Fed Chair appointments.

From now on Fed Chairs are appointed or re-appointed by the President in the first year of his term for his own term. There isn't much being made of this in the media but it is an important change that very much politicizes Fed Chairs in the future, which isn't good. They still get a four year term, like always, but are picked by the President to serve him. This doesn't politicize them as much as Treasury Secretaries, but it is a big step down. And if Bernanke isn't reappointed he will be one of the shorter termed Fed Chairs of history. And to go out of office at this stage of things would cause him to look in history like a failure.

Now we're going to tell you later that there are abundant things any Fed Chair can do independently, on his own, right here and right now, to largely ameliorate the concerns we face.

And many Fed chairs have done all these things over its 95 year life. And if Bernanke worked toward a few other items we describe below he could finish vaporizing all of the prime concerns. But he isn't doing any of those things, and you have to wonder why about that too? Our view is that doing many of those things, acting boldly but independently, signals to the next President that Bernanke will act boldly and independently and thinks he should act that way and hence won't be a team player that will help the new President with the economy come reelection time. But if Bernanke plays subordinate to the Treasury Secretary, the President's "boy" in all things, he is signaling that he is a team player and will do whatever the President and his people need, within reason. We know this sounds terrible but we believe this is what is going on in Bernanke's mind. He thinks he is doing the right thing by posturing to maximize the likelihood that he is reappointed. It is ironic that so many today see CEOs and other high income and wealthy people through jaundiced eyes suspecting them of skullduggery but don't routinely have the same view of public servants. Yet history shows the one area is as ripe for abuse fully as the other.

Think about Obama and McCain. Bernanke was appointed by a President that both the candidates criticize regularly. That has to make Bernanke a little bit suspect to them. For Obama, Bernanke is a Republican appointee. It may seem strange then that we think Bernanke endears himself to Obama by subordinating to the Republican President's Treasury Secretary, but the message he is sending is that the Treasury Secretary is in charge which implies that Obama's Treasury Secretary can be in charge too. If Obama is elected he will want to see how Bernanke interacts with his own new Treasury Secretary, before deciding about whether to reappoint him or pick someone new. McCain, a noted mercurial maverick, who has made critical comments about how he would fire a laundry list of President Bush's appointees if he were President, will feel the same way.

In essence we believe Bernanke has deduced that the only way he can keep his job is to not act as an independent agent but as a steady team player by subordinating to the Treasury Secretary. If he does that he maximizes the likelihood of getting reappointed. To us, this is a most unusual and in some ways perverse stance. And while we're not certain about this motive, it makes sense and fits with his actions. Paulson, after all, by his earlier stated summer Congressional testimony signaled publically that he wanted to see non-banks phased out and regulated like banks. That must have been music to Bernanke's ears. He probably had heard it privately long prior to that and felt like Paulson was a kindred soul. But note, if Bernanke was truly concerned about ending the crisis quickly, as per Paulson's bleating, he would have already slashed interest rates at the Fed's normal mid-September meeting.

### **What went wrong in your forecasting?**

Simply said, short and sweet, we completely missed the signs, and based on the way we've operated over these decades never would have seen them, of Paulson's re-engineering as a concerted plan--until it was too late. We only first started asking the really right questions on September 17<sup>th</sup>, in response to the AIG deal and why all these deals were structured so differently. It wasn't until September 19<sup>th</sup> that we first began to see the answer and the next

week before we had any confidence in what we're telling you in this email. And none of us, you or anyone living, has ever seen an extended panic before as opposed to a normal bear market and recession.

What started as a normal correction morphed into a financial sector panic. Bear markets are common. Panics aren't. The only remotely comparable panic in modern times was the short-lived but scary stock market crash in October 1987, but it wasn't a bank panic. And it was lightening fast and over. Panics are extremely rare. We may never see another broad market panic for the rest of our lives. Prior panics in history are so far back in time that it is very hard to draw meaningful historical comparisons.

Bear markets, on the other hand, are not rare. On average, there's been about one every five years in modern times. Financial panics are not what other modern bear markets have been about. This has not been a normal bear market process. We were looking for factors more typical of bear markets that we have explained many times and you can read about in chapter 8 of Ken's book *The Only Three Questions that Count*. Those factors did not play out, and we were not expecting an all out extended financial panic. So we missed our opportunity to forecast the bear market.

The panic didn't need to happen.

What we failed to envision, and what still seems hard to believe even though we just witnessed it, was that the US government would deliberately work to exterminate Wall Street as it has existed since 1933. We can't restate enough: in just the last four months, the US government has reengineered the entire financial landscape, including the complete decimation of large, independent Wall Street investment banking. Most of that was done in sweeping fashion simply in the last month—the same time that half this year's decline occurred. In the process, all incentive for private capital sources to invest in troubled financial companies has been wiped out, at least temporarily. And that's not good for markets.

If you would have asked us even three weeks ago (let alone ten months) that all independent bulge bracket Wall Street investment banks would soon cease to exist or be controlled by banks or been turned into banks, we would have emphatically said "No". We would have said it would be inconceivable and effectively almost impossible. And that it would cause terrible dislocations. But the big five are gone. Lehman is bankrupt; Bear Stearns and Merrill Lynch have been swallowed up by big banks; and Goldman Sachs and Morgan Stanley have converted into bank holding companies. Traditional banking has been anointed winner, while independent investment banking has been sentenced to virtual extinction.

One funny irony, if there is anything funny in any of this, is the complaints of some members of Congress like Nancy Pelosi and Barney Frank in contemplating the much discussed \$700 billion 'bailout' package that, "We won't write blank checks to Wall Street." They can't. It's gone. It doesn't exist anymore. They're going to be writing checks to banks.

We also didn't envision that the US government would successively nationalize bellwether financial services firms. Fannie Mae, Freddie Mac and AIG are now run by the government, and their shareholders have been basically wiped out.

Nor did we envision the US government's actions postured as solutions to a financial crisis would in reality markedly increase market risk aversion and decrease liquidity. After successive bailouts, arranged buyouts and nationalizations, money markets are near frozen, lending has halted, and asset prices have collapsed.

We always knew it was theoretically possible the government could play the role of judge, jury and executioner of private institutions. We didn't believe it was in the realm of reasonable probability it would wield its power to do so in such rapid, thorough, and severe means as it has this year. And we certainly couldn't conceive that it would happen this year. There was no part to us that foresaw Bernanke and Paulson as anything other than benign—until very, very recently. But the unfathomable happened.

This dislocation has been unprecedented, and was in our minds unimaginable, even after the process had begun. Bernanke and Paulson may have had good intent, but wiping out investment banking and putting everything under banks caused inordinate damage to market confidence. This is what we missed in our forecasting. We think pretty much everyone else missed it too because you don't see much of anyone talking about it now as a driving force and simply no one a month or two ago was suggesting it could happen.

Yes, some people were bearish over the last year, but most weren't. We were wrong in not forecasting a down-a-lot scenario. But we weren't alone. And those who were bearish and right didn't forecast the scenario that has played out. To our knowledge no other major financial services company publicly called this bear—and a lot of them are ones that have gotten gobbled up or decimated in the process. Of the few minor players that did, we are aware of none that called it for the actual reasons that transpired. And that is the way markets are supposed to work. It is what people don't see that moves markets not what everyone talks about. But for us these developments are just too weird for us to have foreseen and probably for almost anyone to have foreseen.

Our being wrong isn't rare among advisors this year. But we are rare in that we are willing to make bearish forecasts and act on them in meaningful ways. As we said early in this email, our finances are aligned with yours to motivate us to do that. We just didn't get it right this time. Of the last four bear markets (1987, 1990-91, 2000-03, 2007-08), this is the first we missed. We are sorry for that. We intend, very much, to be right more often than not in the future as we have been in the past.

### **What lessons have you learned?**

We have observed many factors that will inform our future thinking, including the impact of various accounting and regulatory changes, the government-led transformation of the financial

landscape, the interconnectedness of financing sources, and the intricacy of seemingly countless new varieties of securities—and perhaps most important how to monitor predatory governmental actions by the Federal Reserve and Treasury. We describe the most significant ones elsewhere in this communication.

Unfortunately, it is still too early to draw ultimate conclusions. There is probably still much more to learn. The financial market panic has not completely unwound, so final lessons could well be somewhat different than what we would venture today. And hence we urge you to be somewhat patient. As we fully and finally learn the lessons as this period has finally unwound we will be back to you detailing those.

### **What is your portfolio strategy to recoup losses?**

First, no matter what has happened or will happen, we will remain very calm and won't panic. This means that we continue to analyze what is most likely to transpire in markets over reasonable time frames constituent with your time horizon.

Our conclusion, as we have explained in earlier correspondence, is to remain invested in stocks for equity-oriented accounts. We know that stocks have delivered exceptionally strong returns in the period immediately following prior panics and bear markets. We have no logical basis to believe this period will end differently. You say, "But that is what you've said all year and it is getting old." That's right but we maintain it is also the right thing to conclude even if in the short-term it ends up being wrong. The last stages of bear markets end up being small compared to the subsequent initial thrust of the next bull market.

And, yes, we don't know when the final bottom will occur. Maybe it just did. Maybe it is right ahead. Maybe it is further out. We think it is likely sooner rather than later, so we think it would be a major mistake to sell out of stocks now and risk missing the early rebound. Getting whipsawed doubles the pain of a bear market. You may not believe that now but you will, very much, if you do it.

There are alternative approaches but none are very good in our view. One would be to sell out of stocks now and never contemplate reinvesting again. For virtually all our clients, this would ensure they never reach their investment objectives and would come at an enormous opportunity cost.

Another approach would be to sell out of stocks now and hold cash in the interim before reinvesting in the future. But that raises the dilemma of deciding when to get back in. A decision to reinvest once the market is at higher levels than today is illogical, because the return expected on cash in the interim is negligible. Buying back in at lower levels would be a good outcome, but there is little assurance there will be lower levels or that one would be able to time the bottom correctly and be willing to stomach pulling the trigger amidst panic selling. If you knew how to time the market perfectly you would already be doing it and wouldn't have ever

hired us in the first place. So that alternative doesn't make much sense for you. It makes no sense to us.

Still another approach would be to hedge the risk of owning stocks by shorting other stocks, buying options, or some combination of other sophisticated hedging techniques. But this is still de-equitizing, just another way no matter what you call it. And doing that achieves the same basic result as just selling stocks and raises the same dilemma of when to re-equitize.

Unfortunately, there are no quick fixes that don't involve taking on much larger risks. Thus, we think the right course of action today is to remain calm, be patient amid the volatility, and keep our sights on the returns on the other side of the valley.

It is also important to keep in mind that for the most part the sectors and categories that go down the most in the last stages of bear markets traditionally bounce back the most in the early stages of bull markets. This is why if you want to get out of the categories that have been hurting us since May hoping to do better you're likely to get stylistically whipsawed. It's just another way to get whipsawed. Unfortunately looking for that next bull market sometimes, like with some other things, the best thing to do is to do nothing, which is a conscious act and may make you feel uncomfortable but is still the right and best thing to do. Remember as we say this that we do so knowing our interests are aligned with yours.

### **Is the \$700 billion government rescue plan advisable?**

We don't much like the Treasury's rescue plan that the House voted down on September 28<sup>th</sup> and the Senate modified and passed on October 1<sup>st</sup>. It isn't altogether terrible, and it isn't much going to bother us if it passes, but it contains a variety of problems. First, and people seem not to notice but it will take a long time to effectuate and won't deal with what we have facing us in the here and now.

Initially the government has to hire and structure a bureaucracy to buy the private securities from the banks involving perhaps both employees and outside vendors.

Then they must determine the rules of engagement and actually hold an auction process. This all takes time and is subject to all sorts of hanky panky. It certainly isn't an overnight panacea. There is no way passing the bill means the supposedly troubled securities would be out of the banks' balance sheets in the next few months. And hence the underlying issue of liquidity concerns will remain until then. And with the current administration about to leave office, continuity problems would surely arise. In the next three months most current federal appointed employees will be focusing on where their next job is which means structuring the bureaucracy to do all this probably takes longer to accomplish than any of us might think. Logically it probably falls heavily on the next administration which will have a lot of other things to do in its initial months otherwise and hence have a hard time getting this done fast. Just making appointments in the beginning will be a heavy burden for the new President and his top people.

The original three page proposal delivered to Congress effectively would have given the Treasury a \$700 billion blank check. The ultimate bill, as it sits now, is actually a \$250 billion initial allocation, followed by a second installment of \$100 billion. Any more money, up to the infamous \$700 billion total would require further action by Congress. And we've all learned that doesn't happen instantly.

But even if it was all allocated, the cost to the taxpayer would almost certainly not be anywhere close to \$700 billion. And that's a good thing. Those funds would be used to buy distressed assets, which would later return to the fund interest and principal payments if held or sale proceeds if sold back to the private sector. The net public gain or loss would be the difference between the original expenditure and the total return on those assets.

And counter to what some critics have claimed about this program it is not, by itself, inflationary. The government borrows money, spends money to buy assets, sells the assets after holding them for some indeterminate time period, and then uses the proceeds to pay down debt. The only way that becomes potentially inflationary is if they don't do the last step and use the proceeds to pay down the debt and then monetize that debt.

The basic premise of using the government as a conduit for disposing distressed assets is doable. The Resolution Trust Corporation in George H.W. Bush's years worked but was far from optimal and took a long darned time. But while no one notices right now, the whole thing seems unnecessary and problematic. If the government holds the assets long-term, Congress would have infinite opportunity for mischief. If they quickly sell the assets back to the private sector, then why create the conduit to begin with? There is no magic in this process.

Assuming a revised version of the plan does get passed into law, it may have the beneficial effect of a confidence boost in general and a liquidity boost for banks. But the same effects could be achieved without such unwieldy and abuse prone government intervention.

We don't understand why the discussion has been framed such that the future of mankind seems to hinge on the passage of this package. We wonder why no one asks, "What should be done if this package never passes? What are the alternatives? Is there anything else to do?" Paulson pushes this package, and Paulson works for President Bush, so ultimately Bush supports the notion, although economics has never been his prime forte. So why does Bush want this huge government action taken? Maybe President Bush simply wants no one to be able to say he didn't do anything to prevent recession.

We have a more speculative theory. And this is only a wild theory. But it is no more wild than the notion President Reagan later admitted to that he adopted supply-side economics, cut taxes and ran the deficit up because he knew that with a big deficit the Democratic Congress would be afraid to spend more money and it would slow the growth of government, which was President Reagan's primary but unrevealed goal.

So here goes: maybe President Bush wants to saddle his successor with this big new program to swamp him and his administration in its early days so it can't commit to other big spending plans like nationalizing health care or any of the many things both Obama and McCain have said they would spend money on. It is a wild theory but it isn't that far fetched. It would work pretty well if that was the goal. This program will take so much effort early in 2009 it would seriously distract the next President.

We also question why no one is asking Paulson whether there is a Plan B if the package isn't ever passed. There are indeed better things to do and faster. And it is mindboggling that no one talks of them or even ponders if they might exist. Bernanke in particular could take bold actions immediately and hasn't done most of the things yet that the Fed is chartered to do and has done before in prior bear markets and in fact in a few panics. The Fed has abundant tools to vaporize this crisis it hasn't utilized and the only reason we can see that Bernanke hasn't done so is that he really doesn't believe the basic economy is as jeopardized as Paulson would have you believe—and knows that he, Bernanke, can always do these things later if he really decides he has to. Below we highlight some faster, cheaper, simpler remedies worth trying first, immediately and right now.

### **What other policy actions would remedy the current crisis?**

There are a number of actions that could be implemented immediately that could alleviate many of today's systematic stresses.

- **Suspend Mark-to-Market accounting rules.** Many of the acute problems among commercial and investment banks stemmed from nonsensical accounting rules. The idea that economic fair value of long-dated assets equates with current market value fetched during a banking crisis defies logic. Allowing more flexible treatments like original cost or otherwise redefining the durations of assets and liabilities would greatly ease today's problems. The SEC on Wednesday gave updated "guidance" on how companies could more broadly interpret current rules, but that was a copout because it essentially said nothing new that it hadn't said before. An explicit change should be made that suspends Mark-to-Market and fair value accounting, even if only as a holiday of a few years. Our analysis says the average maturity of these debt packages is about six years, so a four year holiday would give the banks plenty of time to reshuffle all these securities. Further doing so removes effectively all the bank incentive for the bail out plan except that it doesn't inject cash into the banks. Paulson should be screaming to do this, but it probably goes against his grain as a former investment banking CEO who would prefer that if he were still at Goldman the assets be bought and cash injected into Goldman. The Federal Reserve can't do this by itself, but Congress could mandate this a lot faster than it can pass a big bill. Some have said this won't work. We disagree, but suppose they're right—what will it have hurt to do it for a while? There isn't really much of a way to have downside here.
- **The Fed should reduce reserve requirements** from 10% down to 8% or maybe 6%. This is one of the Fed's oldest, and most powerful and tried and true tools and one it

hasn't used since the 1990s. This would instantly create excess reserves. One problem you read of is a lack of willingness of banks to lend to other banks—which is the process of overnight reserves and Federal Funds. Dropping the reserve requirement immediately vaporizes that issue. Again, for those who say it won't work, we say, then it won't hurt and there is nothing wrong with doing it. The Fed can do this today, and all on its own.

- **The Fed should open the Discount Window wide and drop the Discount Rate. And it should do so for non-bank financial services firms that are in trouble as it said it would last summer but never did.** The Discount Window is another old, proven and powerful tool. It is the mechanism that the Fed lends overnight reserves to troubled banks through when they can't borrow overnight reserves via free market "Federal Funds". In the early 1990s they made the Discount Window available to hundreds of banks. Instead of offering money as with AIG at 8% over Libor, an impossible hurdle to clear, they are supposed to offer troubled banks temporary cheap money until they can extend their current liabilities, which is what the Discount Window is, temporary money at discounted rates from the free market "Fed Funds" rate. Hereto, the Fed could do this today.
- **Simply increase the Monetary Base and from it the quantity of money:** This is otherwise thought of as pumping money into the economy which is, again, one of the most basic of the Fed's tools and one it is routinely expected to do in times of recession or panic. We think most people think the Fed has been doing this and it has, just a tiny bit. For the year through September 10, it had grown the monetary base a paltry 2.5%, equal to inflation. It has resisted doing so until about the last ten days, when it has jumped another 8%. If the crisis still persists, then the Fed should further expand its balance sheet way more and truly print. This process would naturally reduce market set interest rates.
- **Amend capital requirement rules.** Allow temporary leniency on capital adequacy rules to troubled institutions, then put them on reasonable schedules to return to more sustainable levels. By forcing the issue of regulatory insolvency on a daily basis, financial institutions have no time to maneuver through current volatility. This change alone can buy time for reasonable workouts and could be done by the Fed tomorrow.
- **Have the Fed oversee healthier banks buying troubled banks (aka shot gun weddings) as it has for 95 years while not participating in other troubled entities capital needs.** A scary part of today's environment is how many assets are falling under governmental control. The Fed needs to not participate and help the Treasury in executing troubled non-banks. This needs to be a broad signal to the world so normal lenders and equity injectors to non-bank financial services firms won't think they need an approval from the government before moving forward as they do now.

Five of these actions can be done immediately and solely by the Fed without outside help. Why not try them? What would it hurt? Yes, there is risk of some sloppy accounting or pushing some problems into the future, but what we're seeing now is panic which is immediate. The panic can be averted. And yes, looser money risks stoking inflation, but banking crises by nature are deflationary. And all these could be gradually reversed later once the panic passes.

Longer term, we also recommend one other action:

- **Create one common financial services regulator.** Today an alphabet soup of regulators oversees American financial institutions: the SEC, CFTC, FDIC, Federal Reserve, Comptroller of the Currency, 50 state insurance commissions, etc. The history of government regulators being cooperative is poor—they just don't get along well--recall New York Attorney General Eliot Spitzer running roughshod over the SEC in the last bear market. Most of the rest of the world has consolidated regulatory regimes. It is time for America to do the same. This would eliminate turf wars and allow more equitable treatment between categories of financial services firms in resolving crises. This one certainly is not a quick fix, and would take an act of Congress, but could have great longer term benefit.

Regardless of whether or not the \$700 billion plan or any or all these steps outlined above are taken, we think this crisis will pass in not very long. The marketplace will work itself out.

### **What is your current view on the economy?**

The economy continues to exhibit mixed signals. For instance, the just released report on US personal income in August came in ahead of expectations at +4.6% y/y and +0.5% since July. At the same time, personal spending stagnated. The export economy surges forward, but many people fear it will stall as other economies abroad slow and the effect of the US dollar's rebound makes exports more expensive.

The most recent quarterly US GDP figured showed decent growth of 2.8% in Q2. But it remains to be seen if the US economy has or will soon roll over into recession. The extreme credit market gyrations make this unclear. If credit market woes resolve soon, the economy might squeak by in ok if not great shape. If not, we will be watching the effect of reduced lending very carefully to determine what corners of the economy are most vulnerable.

Looking abroad, the same problem is true in Europe, less so in other regions. In Europe, much of the risk of the banking system stems from counter-party risk from American financial institutions. The resolution or lack thereof in America will directly affect Europe.

The issues from before the summer had not led to a weakened economy but instead to an economy with three weak pockets, finance, housing and autos. Those three, of course, remain weak. The question is will the recent panic lead to a broader economic retrenchment. That isn't likely if the panic ends soon. The longer it continues the more likely it is the economy worsens.

### **What else should we be thinking about?**

As written about previously, this is likely the first reverse bubble in modern history, maybe in all of history since it is very hard to tell what really happened in far distant history. It is exactly the reverse of a bubble. People understand the notion of bubbles but not the notion of a reverse

bubble. Here, everything is just like a bubble except backwards. All is bad. All news is cast as bad. When the House of Representatives doesn't pass the supposed \$700 billion bailout package, the market falls. When the Senate does pass it, the market falls. All optimism is seen as crazy. A little like in the words of Franklin Roosevelt, this is a time when, "The only thing to fear is fear itself."

We point you to the opening line of Ken's upcoming, next Forbes column: "Though I walk through the valley of the shadow of death, I fear no evil. It seems like everyone else does though." Ken goes on to point out that, "The shadow of death is an illusion." But today, here and now, panic is rampant. This is a panic and you will probably never see a panic again the remainder of your life. The most important rule in an extended panic like we're in, not that we've ever seen one, but from reading about them in history, is not to panic yourself but to stay calm.

The Media plays into all this nicely. For them, always, bad news is good news. This period is doing wonders for the financial media ratings, subscriptions, etc. We expect to hear the media casting everything in the worst possible terms long after the bottom, as long as they can, until this is all long past. Maybe media coverage will get a little better after the election, because that will be off the table, but it will still remain as dour as it can be. That, actually, isn't unusual. It is normal for typical bear markets and recessions and should be just the same for this panic.

We urge you not to take what you read, see or hear in the media too seriously over the next year. This time will pass. Things will be better. There will be a bull market ahead. Most of the sectors that have gone down more than the market in these last gasps of this panic will go up the most in that next bull market. Stocks are super cheap, the cheapest adjusted for tax rates and interest rates in any of our clients' adult lives, at a time people can't see good things ahead. We urge you to remember that bubbles don't last as long as people think they do and reverse bubbles likely won't either. We urge you to remember that we are on your side, that our interests are aligned with yours, that we very much want for your future financial success as you do and are working very hard to understand these times better than others and see the future better than others.

Despite recent months not working out well we have a long history of doing well and are determined to have a bright future, for us and for you, and are committed to doing what it takes to accomplish that for you. We very much appreciate your patience with us as we go through this trying period.

The Investment Policy Committee  
Ken Fisher, Jeff Silk, Andrew Teufel

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