

Advocate Asset Management, LLC

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A Look Backward

The first break in the market's cyclical upward pattern occurred during May of last year. For the first four months of the year, all we heard about was the enormous liquidity in the financial system. Capital was so abundant. Deals were being done with the most meager of opportunities for sustainable profits in order to potentially squeeze out a return that could be leveraged twenty to one by smart money operators who charge a 2% management fee and 20% of the profits. Private equity and hedge funds drew in huge sums of capital with the prospect of uncorrelated riches to the eager limited partners.

Fast forward 14 months and the world seems to be turned upside down. The mathematics are compelling; there are few profits to be had. Twenty percent of zero is zero. Many investors are queued up to exit these funds but the arcane language of many of the offering memorandums have an escape clause. The general partner decides whether to refund the investors' monies or hold it captive under the financial equivalent of a force majeure event. Stories abound about previously successful funds going through bad times.

Investors were busy rushing to invest near a market high. Few, we suspect, read the offering memorandums that outlined in great detail the risks and fault lines of these funds. The ability to concentrate assets, the ability to highly leverage, the ability to search out areas wide of the original investment focus of the fund, etc. Little noticed were the special powers granted to the general partners in times of crisis, the ability to shut down redemptions arbitrarily.

The breaking news last year at this time was the two highly leveraged hedge funds at Bear Stearns. The firm had \$3 billion in assets, or so they reported to their investors. Within a few months, these two funds were closed, as the asset values were not based upon realistic market values but estimates wide of the mark. The two principal players of these funds are, not surprisingly, being investigated for multiple violations of the securities laws.

The market had a rough go at it but seemed to right itself after a furious downslide during July and early August. However, questions began to leak out about structural problems in the financial industry. The press relations experts at the major firms assured investors that other than a few problems, there was no cause to panic. A leading bank holding company purchased Countrywide, the largest originator of junk loans in the world. Within a few months, that investment was worth 50% less than the purchase price. Countrywide's officers are likely to be investigated for their actions.

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The operative source of the problem was, ostensibly, the over-leverage of the sub-prime mortgages packaged or re-packaged into complex securitized mortgage-backed bonds. The markets assumed that the problem, while large, was contained and that time would heal the wounds if the holders of these securities would be given the time to seek “clearing prices” in a balanced process of “price discovery.”

The market made nominal new highs during October 2007 and then began to weaken. As we turned into the New Year, the decline turned into a rout. Major financial institutions jockeyed for the unenviable position of declaring their balanced sheets “impaired.” Top managements were dismissed by their Boards of Directors. Executive search firms were one of the few areas that profited from this dislocation.

Then, in the spring, professional investors began to shun Bear Stearns because of the counter party risk inherent in much of their derivative trading. What if Bear Stearns could not back up its financial obligations? The Federal Reserve Board moved in and forced the sale of Bear Stearns. Its laissez-faire Chairman, James Cayne, saw his personal net worth in Bear Stearns stock plunge from about \$950 million to about \$45 million. What makes this cycle so unusual is that it is usually the customers who get the short end of the stick. This cycle is different in that the major leaders of the financial services firms — and their top lieutenants who usually become enriched from stock options — are getting hammered at least as much as the regular stockholders. Unintended fair play by the gods of investing.

Some market prognosticators declared that the “worst was over.” *We at Advocate did not think so.* Yet, the market rallied to a point in May that, as noted, was within 11% of the all-time highs set in October.

We took a step back and examined the period of 1992 through early 2008. The broad market, the S&P 500, rose almost steadily from 1992 until the bursting of the high tech bubble. It declined in successive waves until the loss in wealth was 40% of the previous overall market high. The wealth destruction affected institutional investors and individual investors similarly, especially those playing with the IPO stocks.

Then we examined the current period, from May 2007 through early May of this year. We grew concerned that the entire basis of the post-war creation of increasingly “sophisticated” financially engineered products was on the verge of collapse. We had alluded to this over the years in past client letters, suspecting that danger was afoot but concerned that we were once again too early. As a prime example, we reduced clients’ exposure to equities starting in 1998 in anticipation of the high-tech collapse’s effect on the remainder of the market, eighteen months before the ultimate top.

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Talk was of problems at Lehman. Then, of the increasing delinquencies of prime mortgages, and car loans, and credit-card default. And through all of this — in spite of the dangers — the US market was off about 11% from its all-time high.

Revisiting Risky Business

We talked and wrote about the inherent riskiness of financial derivatives; that these contracts were not well understood and represented far more danger than most suspected in a non-linear world. The subject of risk was effectively relegated to those occupying the deep reaches of the financial services behemoths; left to the mathematicians and internal analysts whose basic premise was that the party would go on forever. Their mandate seemed to be to push more 'stuff' out the door and increase sales and profits. Hedge a bit here and there but do not upset things by questioning the basic premises upon which these transactions were anchored. Things would recover and the gravy train of outsized compensation would adequately reward those whose services produced paper money that is turning out to be ephemeral.

The central bank of the central banks, the Bank for International Settlements (located in Basle, Switzerland) was sounding notes of caution. No one seemed to be listening; most did not seem to care. The siren song of riches to be had for the taking was re-emerging. The market was convinced that the bail-out of Bear Stearns shareholders was the bulwark of a responsive Fed coming to aid the capital markets. The crisis was declared over. Market pundits declared that the declining market had likely seen its cycle lows.

We at Advocate were incredulous. Could we be one of the few who saw the structural damage caused by decades of over borrowing by consumers, companies, and governments? Is it possible that there were practical limits to over-leverage within the world's free-market capitalist system? Could other problems emerge that were not being discussed in polite company? Who would stand behind the financial institutions that took risk and lost? New alphabet-soup terminology hit the headlines. No sooner had we placed our arms around the dangers inherent in SIVs — special investment vehicles — the off-balance items held by the money-center banks then we were introduced to a new phrase, GSEs or government-sponsored enterprises. Levered at 30-to-1, these GSE control most of the conventional mortgages floated in America. And they are in trouble. Deep trouble. Trillions of dollars at stake with a housing market that continues to decline; turning some loans upside down.

The equity in some of these loans has evaporated and may not recover for quite a while. What will turn around the housing market? The diminishing of desperate selling among those who are relocating, or have to sell, or are so far over their heads financially because they embraced profligate spending? The

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closing of our borders to legal (and illegal) immigrants that stimulated the lower end of the housing market and inspired an important upward thrust for the industry? The renewed ability to gain access to ample credit at affordable rates? The assistance legislated by the hastily drawn-up plans of Congress to mollify angry voters in anticipation of this November's presidential and Congressional elections? The housing industry and its minions plying the image of homeownership as the American ideal?

What happens if the anticipated bounce in home prices does not occur? What if housing prices stagnant after this unprecedented decline bottoms out? Housing construction is one of the most important industries in our country. We cannot export housing to restore jobs in the construction trades. Nor can we heal the other segments related to housing that are in bad shape such as home financing, insurance, real estate brokerage, appraisal, landscaping, etc. What about the decline in real estate taxes that support governmental services, education and the like? Are there municipal bankruptcies on the horizon?

Looking Forward: The Bad News is Not Priced into Today's Prices

We are experiencing the opposite of the virtuous circle — the feared negative feedback loop. And this feedback loop appears particularly severe. Declining demand for housing causes housing prices to decline further. This places pressure on finance companies. They cannot make their margins because they are experiencing higher loan losses. They have to repair their own balance sheets. So, they cannot initiate loans to regenerate the lending process. Reduced values in home prices result in a greater numbers of delinquencies and defaults, thereby increasing economic distress. Consumer spending slows, causing work furloughs, plant layoffs and, ultimately, plant closings. Higher unemployment causes a slowing economy. In the service business, hair cuts and nail applications are stretched out. Doctor visits are delayed unless it is an emergency. Dental work is postponed. Other services are elastic and may be deferred or cancelled entirely.

This is not yet fully discounted in the capital markets. This places downward pressure on the markets themselves. This, in turn, causes market valuation declines in employee retirement plans — most of these are now self directed and take direct 'hits' in terms of diminished wealth.

That the expected overall deterioration in the financial well-being of Americans is occurring just prior to the huge demographic bulge that represents the baby boomers is particularly problematic. Their two main sources of wealth are losing value — their homes and their retirement funds.

There are millions of Americans about to retire. They will begin to draw down their savings and investments to supplement inadequate Social Security payments, in part because the U.S. government has distorted the effects of

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inflation for 40 years thereby rendering the COLA (cost-of-living adjustments) inadequate to meet the needs of retiring Americans.

How Bad this Time?

Our assessment was — and is — that the damage is not over. We believe that there will be a major realignment among financial institutions. Some — perhaps many — will disappear. (That will add to unemployment.)

Congressional committees are now investigating the mess after prudent voices from within the financial sector were shut down by lobbyists plying their trade at the behest of their clients. Congress appears to be always late, but never uneager to gain headlines in home town newspapers, though, especially before an election.

Successive elected officials of the US government squandered the opportunity to address the energy crisis seriously since the first oil embargo of 1973. We count thirty-five years of neglect and institutional incompetence. In a statistic that is breathtaking, the slowdown in sales of large, gas guzzling SUVs and trucks has placed the icon of industrialized America — General Motors — in dire straits; its stock price is at mid 1950s levels. Is it a manufacturing company or a deliverer of health and retiree benefits to a segment of a grateful nation?

There will be foolish attempts by the government to intervene by propping up weak banks and financial institutions throughout the country. Hopefully, we will not repeat the mistakes of Japan that suffered almost two decades of sticking their heads in the sand with disastrous consequences. However, the problems go beyond sub-prime. They affect Alt-A mortgages and prime mortgages. Prescient investors are realizing that the problems extend to consumer loans such as auto loans and credit card debt. These other credit areas are now beginning to unravel, too. A rising rate of delinquencies and defaults by these consumers will exacerbate an agonizingly slowing of the US economy. While our exports have held up, slowing markets in Europe and Asia will moderate this segment of the US economy.

Despite the attempts of governmental officials to sound confident, they really do not know what to do. They have very few policy options. They are boxed in by both domestic and international pressures in a globally linked economy. The sovereign wealth funds that supported ailing U.S. financial companies last fall and this spring are likely to be cautious in committing more billions to enterprises that looked so good just a year ago but whose stock prices have plummeted. So, where will the necessary capital come from? Forced sales of marked-down assets, adding pressure to capital market prices and the realization of larger-than-expected losses, more write downs, and so forth.

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We are in the midst of a major destruction of capital, the likes of which has not been seen since the 1930s. Consumer confidence is near record lows. Investor confidence is in the process of being shattered and the consequences are not fully understood by most Americans. Technological advances will help but the problems of a declining dollar — seen as commodity inflation — will cause the wealth of most Americans to be squandered further. ‘Fixes’ such as increasing tax rates on capital by a frenetic Congress in its first 100 days — capital being a scarce commodity these days — will not be helpful to restoring the environment that will accelerate the healing of the wounds. The pent-up anger of the average citizen will result in attempts by government to over-regulate the damaged economy; they have lost their “entitlement.”
Spending will decline by surprising amounts as reality hits that this isn’t an ordinary slowdown.

The process of deleveraging the world’s financial system will take some time and try the patience of most investors. The fact is, we never really adjusted system wide for the errant speculation of the 1990s. The market declines of 2000-2002 were damaging but we never reached healthy valuations that could support a solid upward recovery. When we look back ten years to the returns of the S&P 500 Stock Index, we find that we have made absolutely no forward progress, a zero nominal return and a negative return after inflation. With headline inflation of 3% and with recent revelations that the effective inflation rate was actually 6% to 7% (when the governments financial ‘tricks’ and adjustments are taken into account), the appearance of wealth was indeed illusory.

Labor was not rewarded in this cycle. Commodity owners are being rewarded. Raw material prices are leading the advance in rising manufacturing costs. Risk and speculation and leverage were amply rewarded, until very recently. And, that may be the operative paradigm for some time. Markets change direction and leadership changes, too. Many of the hot investment hands of the period 2000-2006 are being badly hurt. Some of the major mutual funds that produced above-market rates of returns for years are now getting smashed by their large — and unmarketable — stakes in the financial, real estate and consumer discretionary sectors. This is how longer-term cycles work.

While America remains a military super power, its resources are being squandered. The infrastructure of America is dilapidated. Our educational system (K-12) is a mess. Our children are too busy texting one another in frivolous pursuits; they seem to opt out of true learning, how to think critically, evaluate alternatives, and take action. Our population is aging rapidly. And, we have no leadership at the top to even define the problems and how these issues are interrelated so as to cause a harmful multiplier effect. Our finest university students are augmented by foreigners from Asia that were eager to emigrate here. They added to our brain and gene pools. But without effective

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immigration policies (as our neighbor Canada has enacted), increasingly, they will go home and compete with us. Our loss.

We are squandering our leadership role in the world. If we do not take decisive action, we will slip further and more rapidly to a shared stage where we will be one of several world powers. This was discussed in an article recently written by Farad Zakaria in Newsweek.

The wealth of the US has been and is being shipped overseas to foreign central banks in Asia and the petroleum-based Middle East. We can reduce the effect of all of the dollars we have exported but only by doing what governments have done for centuries, debasing our capital by making it worth less in the world market. This will likely lead to industries and products that undergo a higher rate of inflation while certain other areas — housing prices, for example — suffer a downward trend with an extended bottoming out prices.

Investment Perspective

From an investment point of view, we are well protected with equity exposure of 50% of each client's policy. We are keeping the cash with a very short-term, high quality exposure. We are not reaching for yield, such as those mired in illiquid auction-rate preferreds without any exit privilege. We are owners of strong economic sectors — Utilities, Energy (including Service companies and Exploration companies) and Materials. We have no exposure to Finance, Real Estate (residential or commercial) or Consumer Durables which have been the areas pulling down securities prices. We do not have any International Emerging markets exposure, having exited this area in the spring of 2006 anticipating the sharp downtrends in prices in China and India.

Clients are in the minus column for performance year to date but overall, the recent market plunges were well cushioned due to the small equity exposure and large cash reserves. We are seeking safe opportunities to invest while we remain extremely caution. We prefer to be patient as we purposely want to be "... late to the party." We think that there are still negative surprises out there and we do not feel adventurous to the point of risking further depreciation in asset values. We would rather watch and wait and seek some hedge protection from areas that we have been successful in the past in trading, such as the small-cap US market index (Russell 200 Index).

The Ray of Light of Uncommon Opportunity

One of the beneficial effects of a protracted market decline is that it presents unusual opportunities. This excites us as investors. Periods of sub-par returns means that valuations return to reasonable levels so as to enable smart investors to capture real opportunities for long-term gains.

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We know that the psychology of investors is to be positive near market highs and depressed and somber near market lows. The lower the price levels, the greater the probability of triggering irrational capitulation. We are not there yet but just as we alerted our investors to the dangers now apparent back in 2005 and 2006, we are now in the hunt to find reasonable re-entry points to begin to buy value.

This period of declining market trend will eventually run out of fuel as forest fires that burn out when their supply of wood is consumed. It takes time and patience.