Double, Double Toil and Trouble;
Fire Burn and Cauldron Bubble
(Macbeth)

The financial crisis has evolved beyond anything anyone forecasted and beyond almost everyone's experience. Primary causal factors are debt, leverage, and complexity. There is an old truth about debt and leverage. They do not matter much until they reach levels where they are the only thing that matters. We have reached that cross of doom as it applies to financial institutions. The first hint of this crisis was the 1998 collapse of the hedge fund Long-Term Capital Management (LTCM). Despite three Nobel economic laureates on their payroll, the firm was leveraged one hundred dollars of debt to every dollar of equity. When markets went briefly against them, the firm collapsed. This experience brings up another truth in the financial markets. Know what is knowable and know what is not. One hundred year floods happen and LTCM was not prepared given their high leverage.

Recent months have witnessed a financial game of musical chairs. The firms that were eliminated were the investment banking houses and commercial banks that were the most leveraged, that lost liquidity and counterparty trust. Wall Street brokerage firms like Bear Stearns, Lehman Bros., Merrill Lynch, Goldman Sachs, and Morgan Stanley were leveraged anywhere from twenty-to-one up to forty-to-one. These ratios are great when markets are performing well, but potentially disastrous when times are bad. This business platform has caused most of the prominent firms that were around thirty or forty years ago to disappear (think E.F. Hutton, Drexel Burnham, Kidder Peabody, First Boston, Salomon Bros., etc., etc.). Bank leverage ratios are less, but still high. They tend to range between ten to fifteen dollars of debt to one dollar of equity. Banks have the benefit of a cheap deposit base, but most of their lending is long. A concentration of non-performing investments (securitized mortgages, bad consumer or business loans, etc.) leads to Shakespeare's witches' brew in the fiery cauldron.

The U.S. Treasury has had to step in to stop a systemic meltdown. The main culprit has been the housing market, and specifically, sub-prime mortgages. Complicated securitized mortgages led the unwary to reach for yield and get crushed. Blame can be placed on many doorsteps, but the result has been a freeze-up of liquidity and the withdrawal of credit needed to run the economy.

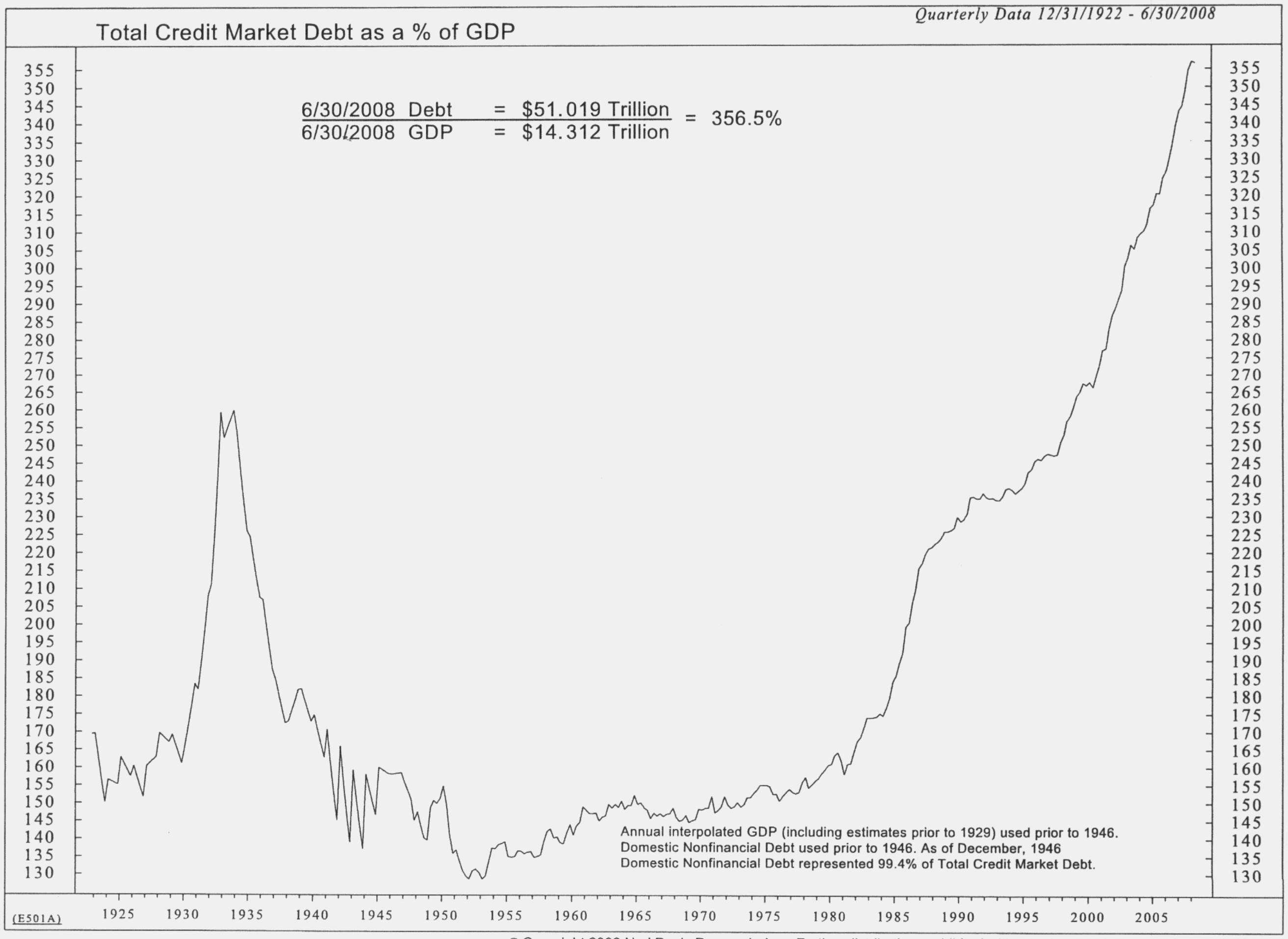
Comparisons have been made with the Great Depression of the 1930's, but they seem stretched. First it is clear the monetary authorities recognize the problem and are doing everything they can, both in the U.S. and globally, to jump start the system. This did not happen in the Hoover Administration. Second, we now have safety nets that did not previously exist—Social Security, food stamps, unemployment insurance, etc. We have entered this period with low inflation and interest rates, plus reasonable stock valuations. The economy and unemployment are in decent shape. Unemployment is now at 6.1% versus 25% in 1931 and the economy, at least by official statistics, has not yet slipped into recession.

A hopeful part of the picture is the solid position of so many non-financial companies and sectors of the economy. This does not get much emphasis in the negative focused financial press. Non-financial companies in general have solid balance sheets and decent operating results. Many consumer staple, health care, energy, and other firms have performed relatively well and their stocks have not cratered. It is a significant positive to see smart investors like Warren Buffet using this period of market turmoil to put Berkshire Hathaway cash to work.

Over

Times of market decline are always challenging. It is tempting to make bad emotional decisions that are not grounded in reason. Be a long-term investor, stick to an investment policy that made sense to you in normal times, look for opportunity presented by undervalued assets. Security markets have a long history of wide swings based on fear at one extreme and greed at the other. Successful investors try to be counterintuitive and look for opportunities in times of trouble.

The healing process will take time, but we have great confidence in the future. Monetary authorities have worked hard to unplug the liquidity bottlenecks both in the U.S. and abroad. Corporations, different levels of government, and individuals now recognize the problems associated with the debt build-up since the 1950's (see chart) and are beginning the de-leveraging process. The economy will tilt into recession, but not fall off a cliff. None of our economic problems are fatal and there are many areas of strength. The price of energy and other raw materials have dropped significantly which should help. Recent strength in the dollar in the foreign exchange markets will reduce import prices. Most important, stocks of many solid companies have declined to tempting valuation levels. Long-term investors, who can live through the pessimism and despair of the moment, should be well rewarded from current market prices.



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