

September 15, 2008

Dear Clients and Friends:

“I approach these questions unwillingly, as they are sore subjects, but no cure can be effected without touching upon and handling them.”

- Titus Livius (Roman historian 59BC-17AD)

What's happening and what does it mean to me? Many of our clients are asking about some of the decisions the Treasury and Fed have made over the past few months, as well as recent volatility and today's market activity. There are also questions about where we, FBB, stand in this situation. This is a brief summary of our take on these interrelated topics:

1. Why did the government “bail out” Bear Stearns and not rescue Lehman Brothers?

The short answer: Bear caught them by surprise, and it was too late to do anything else.

The longer answer(s): The government didn't actually “bail out” Bear in the traditional sense of giving them money; it arranged for Bear to be sold to JP Morgan with a guaranty of Bear's debt, and if that debt performs, the government won't have to put up a dollar. Besides, if you owned Bear at \$100 and then sold to JP Morgan for \$10, you probably don't feel bailed out in the least.

The Fed and Treasury tried for some time to arrange a similar sale of Lehman, sans the debt guaranty, but buyers balked. However, Wall Street has had time to work out much of its Lehman exposure, including unprecedented weekend transactions, and the government has had sufficient time to assess the potential impact of a Lehman collapse, apparently concluding that a Lehman bankruptcy wouldn't pose the same widespread risk as the sudden collapse at Bear.

Further, Bear acted as “prime broker” for hundreds of hedge funds. If Bear had gone under, capital for those funds would have dried up immediately, potentially leading to massive liquidation in the stock market (much more than we've seen.) Thus, the pain on Main Street would have been more severe in a Bear collapse. Our understanding is that Lehman's position is not as threatening.

2. Why did the government rescue Fannie Mae and Freddie Mac?

The government views Fannie Mae and Freddie Mac as essential to the health of the housing market, as it owns or guarantees roughly half of the mortgages in the United States. It is important to understand that Fannie and Freddie were created by the government with a social purpose – to promote housing. We can debate whether or not they should ever have been publicly-owned for-profit entities, but it is reasonably clear in hindsight that the profit motive and a relaxing of regulation over time led to poor management decisions and an overleveraged balance sheet.

But again, as with Bear Stearns, the alleged “bail out” isn’t quite accurate terminology. Common shareholders and preferred stock holders of these companies have been essentially wiped out, and the government is providing a guaranty only to primary debt holders, and only for a limited time. This debt is widely held by pension funds, 401ks, and, increasingly, foreign nations via sovereign investment funds. As the latter are also big buyers of our Treasury debt, the government probably did not want to upset them.

3. Why hasn’t the government been more “helpful” to AIG, Merrill Lynch, Washington Mutual, and others?

Government “bail outs,” for lack of a more succinct term, create a problem of “moral hazard” in which companies may take excessive risk because they have the guaranty, real or perceived, that someone else (the Fed, the Treasury) will pick up the tab should they fail. It is our opinion that the government should not prevent the collapse of a for-profit company unless that collapse would lead to further system-wide catastrophe, as the collapse of Bear Stearns and Fannie/Freddie surely would have. There must be a real “moral risk” involved in investing, and bailing out the imprudent is simply not prudent. Capitalism is a blood sport, like it or not.

Investors in banks, of course, are protected to some degree – provided that the “investment” is in the form of a bank deposit not in excess of \$100,000. In that case, FDIC insurance will provide the necessary support. Even so, the moral hazard created by FDIC insurance and, again, a relaxing of regulations over time, has led banks to overleverage their balance sheets and make loans they shouldn’t have (subprime.) Similar events tore apart the Savings & Loan industry years ago, and led to the collapse of FSLIC.

Further, the federal budget deficit has reduced the extent to which the government is able to intervene without possibly affecting the credit rating of the United States. The Fannie/Freddie debt guaranty effectively doubles the amount of government debt outstanding, even if that debt is kept “off the books.” A downgrade of US Treasury debt from its AAA status, while not likely, would raise borrowing costs for everyone.

4. “What’s Lehman doing in my account?”

Lehman Brothers licensed its name and the bond indexes it created to a large number of mutual fund and exchange-traded fund companies, who then used the Lehman moniker in their own funds’ names. These funds are not operated by Lehman nor are they obligations of Lehman. For example, the “iShares Lehman Brothers 7-10 Year Treasury Fund” is an exchange-traded index fund operated by Barclays Bank, who in turn paid Lehman to use its index (list) of US Treasury bonds that mature in seven to ten years. Why didn’t Barclay’s come up with its own list of treasuries? Well, mainly because Lehman did it first and their indexes are the most widely used by the industry. Similarly, an investment in a mutual fund that follows the Standard & Poor’s 500 stock index would not involve a direct investment in the Standard & Poor’s company.

Also, a few clients joined us with “Lehman Brothers FSB” certificates of deposit. FSB stands for Federal Savings Bank – so Lehman FSB is a federally chartered bank that just happens to be owned by Lehman Brothers. As such, the CDs are subject to FDIC insurance if needed.

5. What does all this mean for the economy?

There are pluses to the situation. We are in the midst of a global slowdown, which means less energy use worldwide. Oil should stabilize between \$90 and \$100 a barrel, by our (and OPEC’s) estimates, though the pendulum swing could drive it somewhat lower in the near term. The financial markets are telling Congress and the President that there needs to be more and better regulation. Our next President and Congress, because of this crisis, will have the moral authority – and responsibility - to enact legislation to better protect the consumer and individual investor. Silver linings amid today’s dark clouds.

6. What’s next?

We believe that we are seeing the beginning of the end of the downturn. Once the financial sector gets flushed out and priced realistically we can move forward. We are cautious buyers of select equities. There is still much to be resolved and American industry and individuals are equal to the task.