



"Unequaled Personalized Service"

September 2008

Market Commentary: Historic Events

September has been filled with many newsworthy events, some of which will go down in the history books. In this piece we touch on the following:

- Freddie Mac and Fannie Mae
- Lehman Brothers Holdings, Inc. and Merrill Lynch & Co., Inc.
- American International Group, Inc.
- Share price vs. business value
- Points of interest for the week ending September 19th
- Potential outcomes of this historic period

On September 7th, the U.S. Treasury and the Federal Housing Finance Authority (FHFA) jointly announced that Freddie Mac and Fannie Mae were being placed in conservatorship. This was an outcome that we had viewed as remote based on then recent regulatory filings, comments from the management of each company and the FHFA. Given the U.S. Treasury's initial injection of only \$1 billion dollars into each, capital does not seem to be the primary motive. It appears that a greater weighting should be placed on political motivations in order to appreciate the outcome. Our investment thesis for Freddie Mac was based on the belief that it could absorb significant mortgage losses during the current period of turmoil and emerge with substantial earnings power in 2009 and beyond. This belief was supported by the pricing power Freddie Mac demonstrated in the last 6-12 months by raising the fees it charges borrowers. We firmly believed that the potential reward meaningfully outweighed the risk of a government takeover, especially when considering that Freddie Mac (and Fannie Mae for that matter) exceeded its regulatory capital requirements as of June 30, 2008. While there had been much speculation regarding a takeover, we felt, based on the most recent public information available at the time, that this would not be necessary. Contrary to public opinion, it is possible that the U.S. Government will one day make a tidy sum from this so called bailout—something that causes us to have mixed emotions. As a side note, throughout Fannie Mae's and Freddie Mac's existence, taxpayers have benefited greatly from these entities via readily available mortgages at affordable rates, yet it is primarily shareholders who have been taken to the woodshed at this juncture.

On September 15th, Lehman Brothers Holdings, Inc. announced its intentions to file for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code. The U.S. Government elected not to provide a financial backstop to would-be-buyers as it had with Bear Stearns. The potential negative impact on global financial markets was not deemed significant enough by the government to justify support. On this same day, Merrill Lynch & Co., Inc. announced that it agreed to be acquired by Bank of America

Corporation in an all-stock transaction, thus marrying a deposit franchise to a broker. A deposit franchise, or traditional bank structure, is proving to have much value. This is illustrated by the fact that many financial institutions (e.g., Bear Stearns, Lehman Brothers) which have failed over the last year or so have not failed due to credit issues but rather liquidity events. Investors (pension funds, sovereign wealth funds, hedge funds, etc.) in short-term financial instruments have abruptly decided to stop providing capital—leaving needy firms squeezed for cash. This risk is lessened when an institution uses deposits as a source of funding rather than short-term Wall Street financing such as repos or commercial paper.

On September 16th, the U.S. Government tossed American International Group, Inc. (AIG) an \$85 billion lifeline in exchange for a stiff interest rate on the two year loan, nearly 80% of the company, and an agreement that the CEO of three months, Robert Willumstad, would step aside. AIG's problems did not stem from its traditional insurance business, but rather from a unit that wrote credit-default swaps. These are instruments designed to insure against losses on an array of assets, such as subprime mortgage securities and corporate debt. Based on coverage by the Wall Street Journal, it appears that the first sign of a pending liquidity crunch was on Thursday, September 11th, when AIG's CEO called the president of the Federal Reserve Bank of New York. AIG's call was reportedly returned on Friday, and an attempt was made to raise necessary funding from the private sector over the weekend. AIG had no success. The U.S. Government's offer was hand-delivered to AIG at 4:00 p.m. on Tuesday. The details of this onerous package were announced on Wednesday. In a mere six days one of the world's largest insurers came unraveled. The speed at which this occurred was both frustrating and astounding for investors. In fact, as of this writing, some shareholders are trying to raise the necessary funds to pay the government back in order to mitigate shareholder dilution. The outcome of this effort will not be known for a few days at best.

Last week's market moves were great examples of something that we have discussed and written about many times over the years and more recently in our latest edition of the Research Perspective: Volatility. Short-term and even intermediate-term volatility is, in our opinion, more often driven by investors' emotions rather than underlying changes in business values. When this happens, a company's share price can deviate greatly from its *business value*, thus creating both buying and selling opportunities.

Points of interest for the week ending September 19th: In spite of last week's wild daily swings, the Dow Jones Industrial Average ended the week down only 34 points. The S&P 500 actually gained 3 points for the week. On a weekly basis, this was a rather docile experience. The U.S. Government announced plans to ban short-selling in 799 financial stocks until October 2nd. This was a coordinated effort with the U.K. In addition, short-sellers will now be required to disclose more information regarding their holdings. Some large pension funds, such as CALPERS, have decided to stop lending certain stocks, thus reducing the number of shares that could be shorted (a short-seller must borrow shares to legally short a stock). The Reserve Primary Money Market Fund "broke a buck" or said another way, its NAV (Net Asset Value) declined below \$1.00, causing a breach of confidence among investors. The U.S. Government subsequently announced preliminary details to insure money market funds for a fee. On Thursday, the concept of creating a government backed entity to purchase bad debt from financial institutions surfaced (this is being identified as the \$700B bailout). A similar scheme was first conceived by Treasury Secretary Alexander Hamilton in 1792 and in more modern times was used in the late 80's. Details and costs are unknown.

What are some potential outcomes of this historic period? As alluded to earlier, the ability to build or the possession of a deposit franchise will once again be coveted. Elected officials will demand more

regulation. In this effort, we are hopeful that rational thinking will prevail and that the pendulum will not be allowed to swing too far the other way— thus stymieing business prospects. Loan underwriting will become more stringent. All financial institutions will require more equity when lending money, at least for the next few years (history shows that lessons learned will soon be forgotten by Wall Street). Equity returns three years from now will likely be better than many currently expect.

EBS's principals and employees invest alongside our clients and likewise experience the impact of the market and our investment decisions. Please know that our research group is working diligently and tirelessly to maneuver through the current environment. Expect volatility and conflicting information to dominate in the near-term, but be excited about the opportunities that it is creating for the recovery that history indicates will come—at some point—when investors and prognosticators least expect it. We continue to be, as we have been for some time, invigorated by what we perceive to be extremely compelling investment opportunities.

Your trust and patience are appreciated. As always, we encourage you to call us with questions or concerns.

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Market and economic data has been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.