

DecisionMaker

Published Quarterly by King Investment Advisors, Inc.

The rating agencies were clearly at the scene of the fraternity party. I'd say Wall Street and the banks provided the kegs, and the rating agencies provided the false IDs.

— PAUL MCCULLEY, PIMCO

Paul McCulley of PIMCO fame most colorfully describes the genesis of the meltdown in the residential mortgage markets. Born of greed and an unregulated market, legions of investment bankers, Standard & Poor's and Moody's, commercial banks and thrifts, and stand-alone finance companies created mortgage products that were doomed to fail. By the end of the bubble, brokers were pushing subprime loans at incredibly low teaser rates with no money down, little or no documentation, and negative amortization payment features. It got to the point that the marginal borrower was not a borrower at all but simply a small-time gambler betting on real estate with someone else's money. With no skin in the game, these borrowers are now following the sage advice of singer, Jerry Jeff Walker, "Leave the key in the old front door lock, They will find it likely as not, With all the things that we have forgot... Before you know it's time we're leavin'."

The global financial markets are still suffering one heck of a hangover. It has been a year since the revelers realized the party was over. Quarter after quarter, the brokers, banks, and insurance companies announce further write-downs in their mortgage portfolios—some real losses and some possible imaginary losses we will discuss later. These painful losses have forced such institutions to sell assets in order to shrink their balance sheets, but the sellers far outnumber the buyers. Prices for all mortgage-related products have fallen dramatically, including the truly safe investments.

Some highly leveraged balance sheets simply cannot be salvaged, and as in past financial emergencies, there must be a high-profile sacrifice in order for

the capital markets to be saved. In the 1998 foreign currency crisis, it was the liquidation of the hedge fund, Long-Term Capital Management LP, and the acquisition of the commercial bank, Bankers Trust, by Deutsche Bank. Last month, Bear Stearns became the poster child for the current credit crisis. With a 30-to-1 leverage ratio and loaded with mortgages, albeit many of them very high quality, Bear Stearns could not withstand the margin calls demanded by its counterparties and depletion of cash reserves. With the aid of a \$29 billion subsidy by the U.S. government, Jamie Dimon, on behalf of JPMorgan Chase, took Bear Stearns out of its misery. While many argue this was a bailout, Bear Stearns shareholders would disagree. Although Bear shareholders will receive approximately \$10 per share, insiders' fortunes were decimated as the stock fell from \$86 at the end of 2007 and from \$150 a year ago. While the typical American taxpayer may not support the Fed's decision to save the day, it was an important stabilizing move for the U.S. financial system.

In the first quarter of 2008, we saw the illiquidity in the mortgage sector spread into other fixed income markets. Once overleveraged



"We're right out of subprime, Mrs. Smith."

hedge funds found they could not sell high quality mortgage securities at reasonable prices, they started liquidating bonds in other sectors, putting downward pricing pressure on all fixed income instruments. Concurrently, brokerage firms were also delevering and reluctant to hold any bond inventory overnight. This has caused several unusual dislocations, including:

a) For the first time in years, high quality municipal bonds are trading at spreads of up to 100 basis points over comparable U.S. Treasuries. As a recent example, one could earn 2.75% on a five-year U.S. Treasury note. Typically, a AAA-rated general obligation bond should, therefore, earn a 2.00% yield due to its tax-exempt status. However, in this unusual environment, the same AAA-rated

municipal bond was yielding approximately 3.25% before the tax benefits.

b) Investment-grade corporate bonds rated AAA are earning yields of 105 to 160 basis points over U.S. Treasuries. These bonds have such a low probability of default that they usually trade at yields only 25 to 35 basis points over U.S. Treasuries.

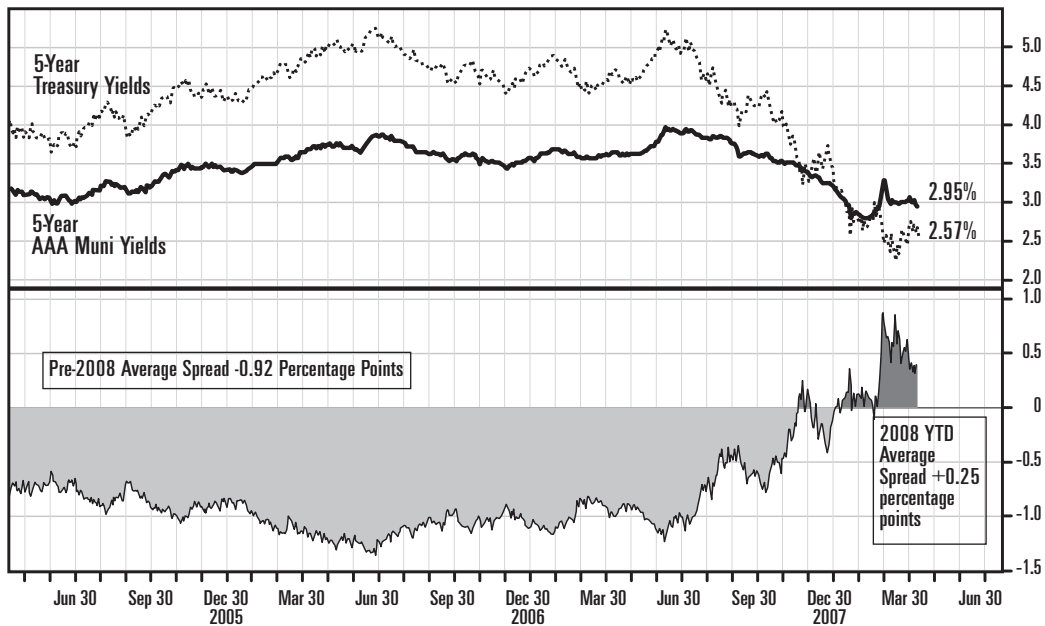
When will markets get back to normal? While there is plenty of speculation by market participants, no one knows for sure. More importantly, when will the investors anticipate stability in the markets? Certainly, long before all the problems in the mortgage markets

are put behind us. Even now, we are seeing critical structural changes being made to improve liquidity in the financial system—the most crucial element in getting the economy squarely on the road to recovery.

Liquidity

Caveat: *The following discussion describes actions the Fed has taken and legislation we believe Congress will pass in the next few months. Please note these are not actions we necessarily want to see happen. We at KING strongly believe in allowing capitalism and free markets to work their wonders allocating resources efficiently—except in unusual times such as these. As Paul McCulley*

SPREAD BETWEEN
5-YEAR TREASURIES AND 5-YEAR AAA MUNIS



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points out, “We shouldn’t have gotten here. We should have had preemptive, prophylactic regulation, three to four years ago, on the creation of these junk mortgages.” Now Washington is dealing with problems with no easy answers, only complex solutions with unintended consequences. The inequities in solving these problems are huge and will run against most Americans’ basic sense of fairness. Foolish borrowers are going to receive a huge handout at the expense of taxpayers who played by the rules. Even so, it should curb the relentless erosion of real estate values currently dragging down the economy.

The Federal Reserve has now lowered the fed funds target rate 300 basis points over the last seven months, the fastest on record. It will probably lower rates again, possibly by another 50 basis points at its policy meeting later in April, which would bring the rate down to 1.75%, the lowest since October 2004. Even with these aggressive reductions, mortgage rates have only recently started their decline and the credit markets have been slow to thaw. The problem is the U.S. government has done little to restore liquidity to the capital markets and to the residential real estate markets up until last month.

Perhaps March 17—the day JPMorgan Chase took over Bear Stearns—will be remembered as the day the capital markets began to make a deliberate, yet choppy, return to normalcy. It was definitely the day Bernanke and his fellow Federal Reserve governors realized they needed to take immediate and drastic measures to restore liquidity in the U.S. as well as the global financial system. On a parallel track, the

Bear Stearns takeover serves as a catalyst for Congress and the President to pass legislation that will supply liquidity to the mortgage and real estate markets.

The Cavalry to the Rescue

We have to give the Federal Reserve some credit for taking at least a few actions to increase liquidity prior to the Bear Stearns meltdown, including:

- On December 12, 2007, the Fed created the Term Auction Facility (TAF), whereby the Fed will auction funds to depository institutions (banks and thrifts) against a wide variety of collateral.
- On March 7, 2008, the Fed increased the size of the TAF to \$100 billion and promised to increase the size of this operation, if necessary.
- On March 11, 2008, the Fed created a \$200 billion Term Securities Lending Facility (TSLF), whereby primary dealers (large brokerage firms) can borrow very liquid U.S. Treasury securities for 28 days using as

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collateral federal agency debt, federal agency residential mortgage-backed securities (MBS), and non-agency AAA private MBS.

With the announcement of the Bear Stearns takeover by JPMorgan Chase, the Fed opened its coffers:

- On March 17, 2008, in order to facilitate the transaction, the Fed made a \$29 billion line of credit available to JPMorgan Chase to be secured by high quality, mortgage-backed securities held on Bear Stearns' balance sheet.
- More importantly, on March 17, the Fed opened its borrowing window to the brokerage firms and investment banks. This was a monumental change by the Fed since these investment banks are not subject to the same regulatory limitations as the commercial banks and thrifts.
- Since then, more government agencies have announced their own policies to promote liquidity in the system, including the announcement on March 19, 2008, by the Office of Federal Housing Oversight (OFHEO) that it would significantly reduce the excess capital requirements for Fannie Mae and Freddie Mac. This should allow these entities to add another \$200 billion of mortgages to their existing \$1.4 trillion portfolios. This is remarkable since it was only a few months ago that the Bush administration refused to consider such a notion.
- The Federal Housing Finance Board announced that it would increase the Federal Home Loan Banks' MBS (mortgage-backed

securities) investment authority for two years. This should enable these institutions to purchase another \$200 billion of mortgage-backed securities.

★ Studying these significant policy changes as a whole, one can grasp the magnitude of the probable and favorable effects on the liquidity of the U.S. financial system. ★

- And, finally, on March 28, the Securities and Exchange Commission (SEC) released a letter clarifying its rules for mark-to-market accounting. Without delving into the details, companies no longer have to consider actual market prices if these prices are the result of a forced liquidation or distressed sale. The SEC's clarification was in response to bitter complaints from very large U.S. companies pointing out the huge write-downs their independent auditors were forcing them to take this year based on the newly effective SFAS 157, *Fair Value Measurements*. As an example, AIG's CEO, Martin Sullivan, claims the company should have only written off \$900 million under a worst-case scenario in the fourth quarter instead of the \$11.1 billion in charge-offs demanded by strict adherence to this new accounting standard.

Studying these significant policy changes as a whole, one can grasp the magnitude of the

probable and favorable effects on the liquidity of the U.S. financial system. Given a little time, these initiatives will help break the shackles currently binding the capital markets.

The Federal Reserve and U.S. government agencies have probably taken all the actions within their power to help the system correct itself. The majority of U.S. financial institutions can now count on the Fed as a backstop for their funding needs, but this is only half the solution. The other half must be solved by new legislation created by the U.S. Congress and approved by the President.

Holding Out a Hero

Government intervention, at this point, needs to shift the focus to an active fiscal policy. As exemplified by the creation of the Resolution Trust Company (RTC) in the early 1990s to bail out the thrift industry, the country now needs decisive government intervention to recapitalize the residential real estate market.

When policymakers approve a permanent solution, the stage will be set for a long-term economic recovery.

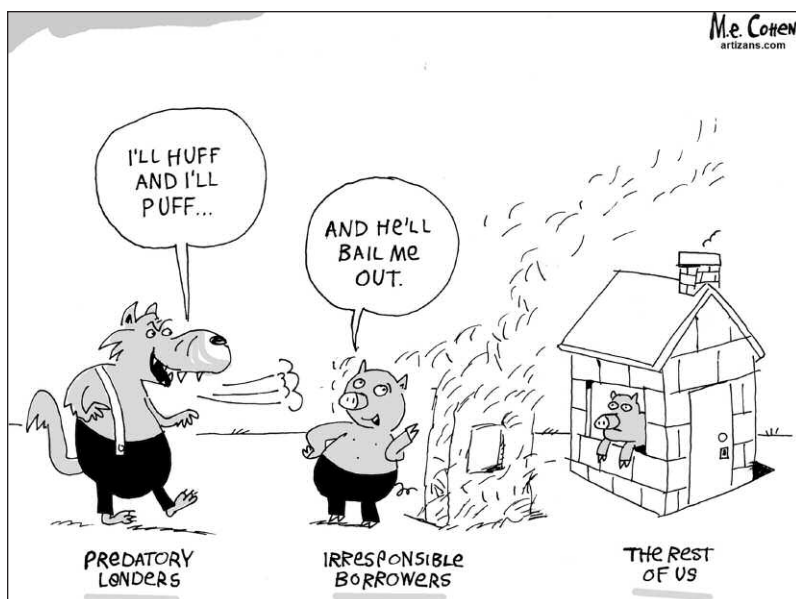
One measure that may offer a framework for legislation can be found in a bill sponsored by Senator Barney Frank (D-Mass.). The basic structure of the plan is as follows:

a) A voluntary program would be established to convert conventional mortgages that are underwater into insured FHA mortgages if the lender is willing to write down the mortgage to no more than 90% of the appraised value of the home.

b) The mortgage holder not only gets a substantial reduction in principal but also gets a low, fixed interest rate. The homeowners are thus motivated to stay in their homes instead of moving out and leaving the lender with yet another empty house.

Senator Frank's plan is estimated to cost \$300 billion, about the same as the tax rebate initiative to be distributed this summer. While

the tax rebates may give a one-quarter bounce to GDP, they will do nothing to stop the deflation in housing prices. The risk in the Frank bill is that it may, quite unintentionally, tempt homeowners who have kept current on their mortgages, to default, regardless of their ability to pay. Should safeguards to prevent gaming the system be incorporated in any legislation, certain aspects of the Frank bill may be a step in the right direction.



★ While some investors may see the current environment as treacherous, as long-term investors, we see the current environment as an outstanding buying opportunity. ★

The big question is whether the Senate Republicans will agree to sign off on legislation soon. Philosophically, the Republicans are not on board since the Frank plan bails out foolish or speculative mortgage holders at the expense of the conservative American taxpayer. However, it may be the only way a typical taxpayer avoids having a boarded-up and abandoned house next door. Remembering this is a Presidential election year, if the Republicans do not see an improvement in the economy soon, Congress may well gravitate toward some legislation that embodies the main thrust of the Frank proposal.

Lessons to Learn

Every decade or so, America makes a colossal financial mistake, usually based on greed. This time around, out of control mortgage lending led to a deteriorating residential real estate market and a freeze in the liquidity of the capital markets. Conversely, America also has an amazing ability to recognize its problems and fix them using a combination of free markets and government intervention. Although the details of the solution are yet

to be determined, they undoubtedly will include increased federal regulation for the financial industry, particularly investment banks. Given the need for such a drastic move by the Fed to save Bear Stearns from bankruptcy to avoid the subsequent fallout in the credit markets, investment banks are likely to face much stricter regulation regarding leverage similar to existing regulation for commercial banks. Hedge funds, currently unregulated, are likely to come under more scrutiny as well. As always, we will eventually find a solution and then get on with life and business as usual. Once the sense of trust and liquidity are restored, credit and equity markets will again return to a sense of normalcy.

Given the global ramifications of the problems in the U.S. financial system, international financial markets are not immune. Foreign market indices are lagging along with their U.S. counterparts. While some investors may perceive the current environment as treacherous, as long-term investors, we see the current environment as an outstanding buying opportunity. In the stocks we are holding, short-term fears are already well reflected in the stock prices. Our long-term time horizon gives us the ability to act on how businesses will look several years from now and not react to whether fear will grip the markets next quarter.

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The year 2008 marks KING's Twenty-Seventh Anniversary. Our professional staff includes investment managers, security analysts, and other specialists qualified to meet the needs of our individual and institutional clients. We are committed to creating wealth for our clients in the long term.

Over the past twenty-seven years, we have successfully navigated through both good and challenging markets by adhering to a discipline of value investing geared to evaluating ever-changing data and markets.

Our philosophy focuses on the valuation of businesses and their economic worth as measured through cash flow and not accounting artifice. Our work in equity and balanced accounts, which includes fixed income instruments, helps each type of account. Many excellent fixed income opportunities develop as a result of our research in equities, and vice versa.

We eschew "market timing" as theoretical nonsense divorced from the real world of investment decision-making and investing. Cash will accumulate in client portfolios when we do not find stocks that meet our selective criteria.

We are confident that the knowledge, experience, and dedication of our investment team, and the application of a disciplined process which has worked successfully over long periods of time, will continue to reward our clients in the years to come.

SOURCES FOR THIS ISSUE

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