

# DecisionMaker

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## *“Show me the multiplier!”*

— FROM AN UPCOMING FILM, *JERRY MAGUIRE II*, IN WHICH TOM CRUISE REPRESENTS BANKERS AND ECONOMISTS INSTEAD OF ATHLETES

The U.S. Treasury and the Federal Reserve have restored confidence in the country's financial markets. The frozen financial system is thawing, and the short-term credit markets are back to more normal spreads. Liquidity has dramatically improved as evidenced by the narrowed spread of commercial paper and other short-term rates over Treasury bills. Moreover, our nation's major financial institutions appear stabilized even while facing significant additional future write-offs. While we will continue to see liquidations and forced mergers of smaller and regional financial institutions, the government has shown the resolve to contain any further systemic risk to the financial system.

Even so, stabilization of the top of the financial pyramid has not created a positive trickling down effect on Main Street America. The unemployment rate is heading toward 10%, and we continue to read the horror stories of battered entrepreneurs and struggling consumers. A large number of investors are puzzled by this conundrum.

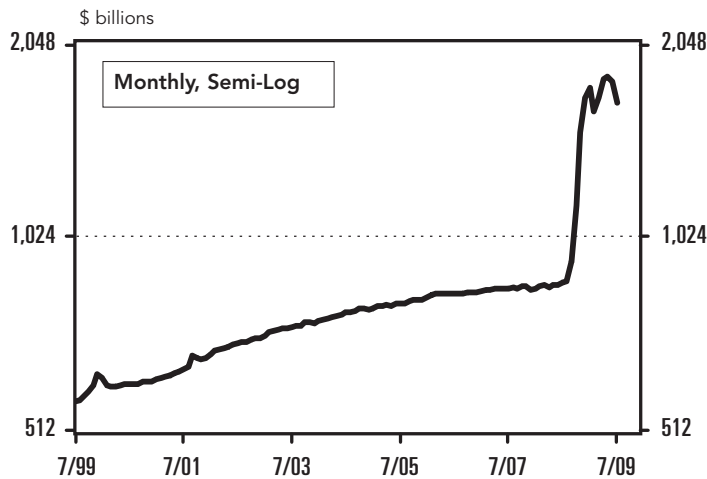
To understand our economy's current doldrums, let us briefly discuss monetary economics before moving on to some of the real factors behind the country's credit crunch.

### IN SEARCH OF LITTLE “M”

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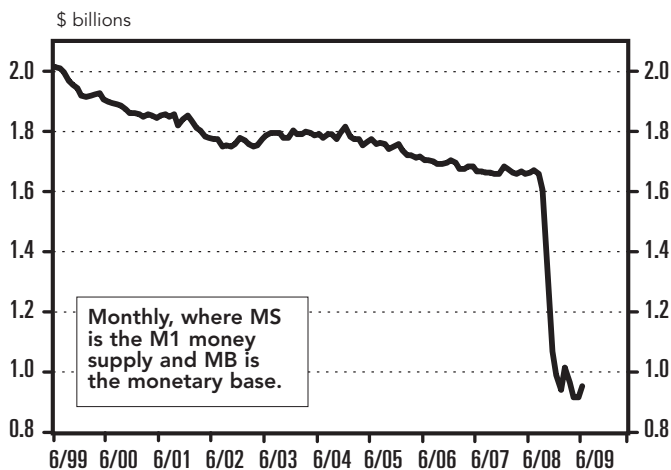
The Federal Reserve controls the monetary base, which is sometimes called high-powered money. Economist Art Laffer gives a succinct definition of how the monetary base is created—“The way the Fed controls the monetary base is through the net purchases and sales of bonds, commonly

### MONETARY BASE THROUGH JULY 1, 2009



SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE, H.3

### MONEY MULTIPLIER THROUGH JUNE 30, 2009



SOURCE: LAFFER ASSOCIATES AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE, H.3

referred to as open-market operations, whereby the Fed increases or decreases its liabilities to member banks, i.e., reserves.”

Since August 2008, the monetary base has surged as the government and Federal Reserve responded to the financial crisis. Quickly increasing the monetary base was one of the Fed’s prime weapons in stabilizing the country’s financial system. In a normal economy, an increase of this size would help stimulate the economy, as the banks would make loans on these increased reserves. On the negative side, such an increase in the monetary base would normally increase the money supply at a rapid pace, signaling increasing inflation.

This, however, is not a normal recovery. We are experiencing the “new normal,” a phrase coined by PIMCO’s CEO, Mohamed El-Erian. In his words, “The next few quarters will be dominated by the aftershocks, driven not by a financial system in disarray but by the slower process of structural adaptation of the real economy, the political system, and

the financial services industry itself.... All of this constitutes an inherent part of the world's bumpy journey to a new normal."

In terms of monetary policy, this new normal is restricting little "m," the money multiplier. Multiply "m" by the monetary base and you've calculated the M1, the money supply. But as you can see in the chart, the money multiplier has fallen off a cliff. While the money supply (M1) has grown quickly over the last year, it has not kept pace with the increase in bank reserves. Consequently, it is not stimulating the economy to its fullest extent but, at the same time, it is not yet sparking inflation.

Banks, loaded with plenty of reserves, should be making loans to creditworthy borrowers in order to increase their profits. Instead, they are maintaining high reserves in anticipation of further loan write-offs, which would eat into the equity capital. Once banks become more comfortable about their future outlook, they will start to increase loans, which should push the money multiplier upwards toward its historic average, resulting in an increase in the money supply. Eventually, the banks will slow lending when they become reserve-constrained again. But this is the new normal, and lenders are not who they used to be.

### THE STEALTH CREDIT CRUNCH

While there are several important factors for the relatively slow growth in the money supply, one of the more fascinating and revealing is the emerging evidence of a "stealth credit crunch," a period where sources of potential new credit to homeowners, consumers, and small business owners are being cut back. Tom Mitchell, a research analyst at Miller Tabak + Co., first wrote about these off-the-radar trends in mid-June and continues to report on different facets of the problem. Some of Mitchell's more inter-

esting observations include: the credit card cutbacks by American Express for small businesses, the mishandling of TARP funds by the government, and the loss of expertise in bank lending officers.

### "You're pulling my credit line—priceless!"

Remember when American Express wanted to be the business partner to growing small businesses? Not any more. Anecdotal evidence indicates that American Express is closing or cutting back small-business and personal accounts without regard to credit histories or any outstanding borrowings on the accounts. All of this happens without discussion or warning to the cardholders. *The New York Times* indicates that 59% of the 27 million small businesses in the U.S. rely on credit cards to finance day-to-day operations. These borrowers are unlikely to quickly find alternative sources of new credit in the current lending environment.

The possible bankruptcy of CIT will be another blow to small business owners. CIT is the primary source of funding for thousands of small and midsize businesses. While there are other banks that would love to pick up the crown jewels of CIT's lending business, its demise may be a psychological blow to its one million small businesses that may see their lines of credit shut down, even if it is just temporarily. Such a shock could motivate these entrepreneurs to stash even more cash and reduce future spending to grow their businesses.

### "Bankers? We don't need no stinking bankers!"

There is much evidence that the TARP money given to the banks by the Federal Government is not resulting in net new outstanding loans. In fact, \$68 billion in TARP funds have

already been repaid by creditworthy banks, the banks most able to make new loans and help spur the economy.

Seeking to spur investors' interest, several such bankers from across the country have visited KING's office. They all had similar stories of government "help." In December, the FDIC approached these CEOs, strongly suggesting it was the patriotic duty of the banks to take the TARP loans in order to make loans and acquire their distressed neighbors. After the New Year, the media and the U.S. Congress quickly reversed course. To the bankers' dismay, they were portrayed as crooks for accepting the money. As the local press hounded these executives at their homes, Congress forced the FDIC to develop new rules for these bankers who had accepted the TARP funds. As an example, Jamie Dimon,

the CEO of JPMorgan Chase, blew a gasket when the FDIC said he could no longer hire foreign workers in the U.S. It wasn't long before Mr. Dimon and other bankers said, "Why bother?" and repaid the TARP money to the FDIC. The idea of working any longer under the government's thumb was just too painful, so the resources to make new loans were lost.

### **Credit Analysis 101: Bankers flunked the course!**

The Federal Reserve surveys bank loan officers quarterly to judge the nation's lending climate, most recently in April 2009. Even after several previous quarters of tightening, the survey showed that 30%-40% of banks were still tightening the credit screws in April, with none of the banks easing. In addition, the



survey showed that 65% of banks were raising pricing on commercial loans and, again, none was lowering pricing. With all their excess liquidity and increased profitability, why are the banks not lending? One primary reason may be the lack of experience and formal training of those in the trenches—the bank loan officer corps.

Until around 1990, it was commonplace for large banks to have formal credit training programs, often lasting more than a year, for their apprentice banking officers. These young women and men spent months learning how to evaluate a company's physical assets and, more importantly, how to evaluate the ability of a business to generate and grow free cash flow. These credit analysts would work long into the night "spreading statements" for the bank customers. Their analysis included adjusting a company's balance sheet for noncash charges such as depreciation and amortization, projecting a business's working capital needs through changes in accounts receivables and payables, and fine-tuning the inventory accounts based on last-in, first-out accounting. Once completed, the budding credit analyst would present the spreadsheet to the borrower's veteran loan officer who would evaluate the analyst's work and explain how it was used in evaluating a company's credit position. Slowly, but surely, this young analyst evolved into a credible junior lending officer.

From the 1950s through the 1980s the money center banks were renowned for their formal credit training programs, with JPMorgan setting the gold standard. The super-regional banks were not far behind. In Texas alone, RepublicBank, Texas Commerce Bank, and InterFirst Bank created programs that supplied a steady stream of top-notch officers to the region's banking and financial community for years.

### MONETARY BASE

It is the amount of money in the economy, comprising coins, paper money, and commercial banks' reserve deposits with the Federal Reserve. The money multiplier (m) calculates the maximum amount of money that an initial deposit can be expanded to, with a given reserve ratio—such a factor is called a multiplier.

Thus the money multiplier, m, is the inverse of the reserve requirement, R.

$$m = \frac{1}{R}$$

For example, with a reserve ratio of 20%, this reserve ratio is expressed as:

$$R = \frac{1}{5}$$

So the money multiplier, m, will be calculated as:

$$m = 1 / \frac{1}{5} = 5$$

This number is multiplied by the initial deposit to show the maximum amount of money to which it can be expanded.

This began to change in the early 1980s as the super-regional banks were absorbed or acquired by major national banks. RepublicBank and InterFirst were absorbed by what is now Bank of America, and Texas Commerce was acquired by JPMorgan Chase. Across the country, the traditional bank credit training programs were dismantled and replaced by a new training system in order to reduce costs.

Starting in the 1980s, what we now call "sub-prime" lenders, such as Household Finance and Associates Financial Services, restructured their entire books of unsecured personal loans, converting them into secured loans backed by second liens on their borrowers' homes. This was a win-win for both sides. The lenders cut their credit losses and the borrowers received lower interest rates.

Seeing this success story of converting personal unsecured loans into secured credits, banks such as Bank of America and Chase

leapt at the chance to extend this model to the commercial sector. Between 1992 and 2007 the ratio of bank loans collateralized by real estate to total commercial loans increased from 20% to 60%. Again, the banks received great collateral coverage, and the borrowers paid lower interest rates, so everyone was happy.

There was, however, a “side effect” on the upcoming corps of bank loan officers. Loan officers trained in the late 1990s and 2000s have primarily learned to extend commercial credit based on the appraised value of a borrower’s real estate holdings without the benefit of the formal credit training programs of the past. These young loan officers never learned to apply the rigorous tools of traditional credit analysis for the underwriting of unsecured loans, primarily not being able to estimate a borrower’s future ability to generate cash flow to pay the interest and principal on a loan.

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★ Even in these trying times, we believe the markets continue to offer the potential for long-term wealth creation—although on a much more selective basis than we have seen in many years. ★

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With residential and commercial real estate values now falling, the banking system is burdened by term loans and lines of credit that are collateralized by properties of shrinking value and coverage. Ironically, during

this time when businesses need availability of credit more than at any time in the past generation, bank officers are cutting credit lines, raising prices, and shortening maturities. Establishing a renewed paradigm of cash flow lending will take time—it will not happen overnight. Sooner or later, the Federal Reserve and the Obama administration will get the money flowing again. Meanwhile, there could be a painful drought of useful liquidity in the economy before this comes to pass.

### IMPACT ON KING’S BUSINESS VALUATION APPROACH

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Even in these trying times, we believe the markets continue to offer the potential for long-term wealth creation—although on a much more selective basis than we have seen in many years. While we are decidedly not “Pollyannas,” neither are we “Chicken Littles.” We believe there are significant opportunities for long-term investors in these challenging times—just as there were in the 1970s and even in the 1930s.

#### Short term: Cash is king

In the short term, we are particularly wary of investing in companies with over-leveraged balance sheets or with an overexposure to troubled residential or commercial real estate. When considering potential investments, we look for companies that have little or no debt refinancing requirements over the next two years. If a company under consideration requires debt refinancing, it must have ample cash or cash flow to meet these refinancing needs internally.

Companies hoarding a war chest of cash, benefiting from low borrowing rates, and avoiding near-term debt maturities are in an enviable position. With peers and smaller

competitors severely over-leveraged, these liquid companies are relishing the opportunity to purchase their troubled brethren at reasonable, and sometimes distressed, prices. As recently as a few years ago, there would have been huge premiums attached to such acquisitions—and then, only if the potential seller would even entertain an offer.

Efficiency is imperative. As companies around the globe have seen their revenues and volume growth decimated by the recession, it is evident that companies which are low-cost producers have an enormous advantage over their competitors. Better yet are the businesses that are semi-monopolistic or, at least, oligopolies.

#### **Long-term: The return of little “m”**

Looking farther out, selectivity is critical. The global economy is undergoing massive deleveraging that is being offset with a huge, unprecedented, inflow of money and fiscal stimulus. This can more readily be seen in the unprecedented growth in the monetary base as discussed earlier.

And at some point in the next few years, little “m,” the money multiplier, will begin to recover. Starting slowly, but at an ever-increasing rate, bankers will begin to lend on cash flow instead of real estate valuations. The U.S. Treasury and Federal Reserve will smooth the ruffled feathers of the bankers in order to release the lending capacity held in the coffers of financial institutions. And, the credit card issuers will again allow small businesses access to the liquidity they so desperately need. All of these changes will force little “m” up to a more normal level and possibly beyond.

Given the record-breaking monetary base, little “m” will no longer be just the money multiplier—but perhaps change its name

to Big Bold-Faced “M,” the monster money multiplier. As the economy improves and “M” accelerates, the money supply (remember, monetary base x money multiplier = money supply) could increase at much too rapid a pace in releasing its \$5 trillion of lending capacity. At that point, the Federal Reserve will have the unenviable and very complex job of reducing the monetary base, thus applying the brakes to the economy. If the Fed does not move in a timely manner, inflation will quickly spiral upwards. If it moves too quickly, the Fed could kill off a fledgling recovery.

We believe that the Federal Reserve will try to avoid the recession scenario at all costs. If the Fed misses the mark, it will be to the inflationary side. This should not happen in the next year or possibly two. The global economy is still too mired in recession and too much excess global capacity exists for the CPI or PPI to rise significantly in the near term. Even so, eighteen months from now, inflation may start rearing its ugly head.

In view of these potential developments, we are keeping the average maturity of our fixed income holdings short. Inflation causes interest rates to rise, thus causing the market value of long-term bonds to decline. By keeping our bond maturities shorter, client portfolios will be somewhat insulated from price declines as a result of rapidly rising interest rates.

We believe a recovery will yield compelling equity investment opportunities. Potential inflation pressures may create a headwind for some industries, but a tailwind for others. Our Business Valuation Approach will continue to be focused on uncovering rewarding long-term investments for client portfolios.

Pat H. Swanson, CFA  
Managing Director

The year 2009 marks KING's Twenty-Eighth 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-eight 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

Calamos Advisors LLC; *Forbes*; *GMO Quarterly Letter*; Gluskin Sheff + Associates Inc.;  
Hoisington Investment Management Company; Laffer Associates; Miller Tabak + Co., LLC;  
PIMCO; *The New York Times*



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