

MARKET NEWS

Keeping our Clients Informed

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If Computers Ran the World...

I am a big fan of science fiction films and one of my all-time favorites is the first Terminator movie. With the advances in technology that we have seen in the past twenty years, one has to wonder if we're destined to be ruled by machines one day.

What we have witnessed in the financial markets over the last year and a half should give us all the peace of mind that machines will never be that smart. Why? Because we are living in the aftermath of what happens when people defer decision making to computer models.

One of the questions continually posed in this financial debacle is how did so much risk pile up in our financial institutions? Where were the risk managers? I think this question was best answered by Bank of America's president Ken Lewis when he said, "I think the industry relied too heavily on financial models and not enough on sound banking." One might conclude this was an understatement.

It is fair to say that as financial instruments have become more and more complex, valuing them has become more and more esoteric. It's a sort of man bites dog scenario, when the very instruments that wrecked the likes of AIG were in fact designed to help manage risk.

I am not necessarily opposed to financial models. We in fact use many of them in our business almost daily. The problem is that models are designed to work within a normal range of expectations. The assumption is that because abnormal times are short lived, whatever you are modeling will ride out instability until order is restored. The premise of investing for the long-term is built on this theory – endure the short-term volatility and benefit from the long-term trend.

Relying on models introduces two significant issues that one must always remember. First, the model may be flawed with incorrect assumptions about the future. It can take a very long time to thoroughly test the validity of the expectations, and relatively new financial instruments haven't benefited from living through a variety of market and economic cycles. Thus there is no substitute for the common sense that comes with human

experience. Around here we call it the sniff test. Sometimes you can look at the projections and just know something is off. If it looks too good to be true, it is. This is what Ken Lewis refers to as sound banking.

The second problem with financial modeling is that abnormal times can stick around for a while. There is a saying that the market can be inefficient longer than you can be solvent. This is what the banks are dealing with now. If you're going to play the long-term averages, you'd better make sure you can stick around for the long-term. The best way to ensure that you cannot ride things out is to borrow short-term money to buy speculative long-term assets.

The majority of "toxic assets" have not experienced any losses, nor will they. Some estimates put the good assets vs. bad assets ratio at no more than 70/30. The reason there is no market for the good assets at a reasonable price is because no one knows which securities are the minority (30%) that will experience losses. If a firm margined their portfolio to buy these securities, they'll have a really hard time sticking around to discover which assets can be sold at a decent price. The same holds true if you are a bank and your capital is based on the value of these complex securities.

Roughly ten years ago, these two forces converged on the hedge fund Long Term Capital Management. In hindsight the fund's massive collapse was predictable due to disproportionate reliance on both theoretical finance and high leverage. Their story makes an interesting read (if you are into this sort of thing) in a book called *When Genius Failed: The Rise and Fall of Long-Term Capital Management*. The book is one of the suggested readings on our web site: <http://www.alderfinancial.com/books.htm>. At least computers would learn from their mistakes... only ten years later, it is unfortunate that people have not.

TARP Deux

Since managers cannot wait to determine which troubled assets might eventually prove beneficial, the Treasury Department finally released the long-awaited details on their plan to remove any distressed assets from bank balance sheets. In keeping with the administration's theme of "rename

it to minimize it,” the assets formerly known as toxic will now be referred to as legacy assets. It does sound more pleasant – hat tip to the folks in marketing.

The two types of legacy assets are legacy loans (real estate loans) and legacy securities (securities backed by real estate loans). There is a different plan for the two asset groups. Here is how they work:

Legacy Loan Plan

1. Banks identify loans that they want to sell.
2. The FDIC will examine loans and determine the capital structure that the FDIC will guarantee. The FDIC will guarantee debt up to 6:1 (debt-to-equity).
3. FDIC auctions the loans to the highest bidder.
4. The buyer issues FDIC guaranteed debt.
5. Half of the equity is provided by the buyer and half is provided by the Treasury.
6. The buyer manages the assets.

The Legacy Securities Program

1. The Treasury Department will select at least five Fund Managers.
2. A selected Fund Manager will raise capital.
3. Once the capital is raised, the Treasury will invest an amount equal to the capital raised by the Fund Manager. This money will come from the Term Asset Backed Securities Facilities (TALF). This is a major change in the TALF program, which was supposed to be used for newly issued securities, not existing securities.
4. The Treasury will loan an amount equal to the Treasury's equity investment, with the consideration of additional loans.

The primary intent of these programs is to leverage the government's investment and share the risk by attracting private capital. In theory, with the questionable loans and securities removed, the banks can once again attract private capital and repay the government's TARP investment. In addition to having a stable capital base, banks should be in a position to grow their lending again. So far BlackRock, Legg Mason, and Pimco have announced their desire to participate. They are also likely to start closed-end funds which will allow smaller investors to participate too.

There are several reasons this plan is attractive to private investors. First, the federal debt issued to the investors is non-recourse (secured). Second, the terms of the financing are set to match the underlying assets being purchased. This is important because it eliminates

the refinancing risk that got so many investors in trouble when the credit market dramatically tightened last year.

One big question that this plan does not directly address is what the participation level of the banks will be. There has always been a market for these securities – at some price. In fact, we have been a buyer of this paper, but only at ridiculously low prices. The problem is that there has been a very wide price gap between what buyers (private investors) and sellers (banks) are seeking. This plan addresses this problem only in a very indirect way.

It is hoped that the liquidity in these securities will pick up because the liberal financing terms should afford private investors the ability to pay more than today's offers and thus shrink the price gap. Also, the FDIC will surely be pressuring the banks to get rid of these assets by participating.

If the troubled assets are underpriced due to fear, the plan may work. But if the assets are truly that bad (toxic), the plan will likely fail. The government thinks this is a liquidity problem and thus is trying to close the price gap. If that is the case, this plan will probably work because the taxpayer money will bid the prices back up to normal levels. If the securities turn out to be truly toxic, the government loans will lose badly.

The government has a fundamental problem: the banks have losses and the government wants to hide the fact that it is transferring more taxpayer money to these losing banks. As a result, the plan is an overly complicated process designed to make it appear as though we are investing alongside private investors on an equal basis. Nothing could be further from the truth. What we are really doing is subsidizing the buyers.

These subsidies arise because the government is taking on all of the interest rate risk and credit risk of these loans. Because the government is allowing the private investors to employ large amounts of leverage, those investors have relatively little capital at risk. I find it ironic that high leverage on non-recourse loans is what got us in this mess to start with.

The market had a huge rally on the news of this plan. It is possible that the market really liked this news. It is also possible that the market was rallying due to the public sentiment that turned against the idea of imposing a special 90% surtax on the AIG employees. In addition, during this entire crisis, the market has always rallied when the government bailed out shareholders.

With all that said, we believe this plan will help. But we think it will be more costly than necessary and that the cost will be shouldered by the wrong people.