April 8, 2008

Saving the System!

How did our mortgage and credit markets get into such turmoil, and how did it happen so quickly? It is almost impossible to pick up a newspaper without seeing a reference to this predicament. Billion dollar writedowns have become a daily occurrence with major banks and brokerage firms. And, if Bear Stearns is not in the news, it is conspicuous by its absence.

The problem started a few weeks ago as a relatively minor disruption precipitated by the payment failure of a few substandard mortgages, known as subprime loans. Suddenly, like wildfire, the contagion spread throughout the credit markets. Fears began to escalate and investment bankers and underwriters simply stopped making offers to buy existing mortgages or create new ones. Keep in mind, these are the people who are in the business to buy and sell loans. Not only did they refuse to buy the low quality mortgages, they also refused to make bids on high-quality performing loans. Their reluctance spread to other types of debt securities, even including a particular type of high grade, tax-free municipals. Certain types of preferred stocks, corporate debt, or municipals are known as auction rate securities because their rates are set at weekly auctions. By early March, Bloomberg reported that over 70% of these auctions failed due to a lack of bidders. In a matter of weeks, the normal ebb and flow of the credit markets almost ground to a halt.

Enter Ben Bernanke to the rescue. Lacking only the proverbial white horse, he entered our chaotic financial scene with his posse of Federal Reserve Board Governors, to save the day at the eleventh hour. Bottom line – along with other steps they made to bolster the credit markets, the Fed guaranteed $29 billion of Bear Stearns assets, paving the way for J.P. Morgan to buy the entire firm. In doing this, Bernanke opened himself and the Fed to an avalanche of criticism, as to why he was using taxpayer money to save the bad guys. In his defense, however, it was not his intention to rescue Bear. In fact, shareholders who had seen their stock worth over $100 per share as recently as December, will now receive only the takeover value of $10. Nor was he trying to save the foolish borrowers or greedy lenders whose loans should have never been created in the first place. He was trying to avert a domino effect in financial markets. Too many other major institutions are entwined in Bear's financial dealings, not to mention the psychological effect on investors worldwide, which could have increased illiquidity.

To some extent, we are a proponent of Adam Smith's "invisible hand." This is a metaphor, which states that individuals pursuing their own self-interests tend to also promote the good of the whole community. Governments are there to temper the extremes and act as our conscience when our self-interests are foolish, greedy, or unjust. Had the Federal Reserve not intervened, we believe that the credit markets would have eventually sorted themselves out, but they would have done so with a fair degree of pain. That pain would have manifested itself in a worsening recession, and we all know that is not politically palatable. Certain political interests are pushing the Fed to become increasingly more aggressive in our credit markets and this is the direction they appear to be taking. In setting themselves up as buyers of last resort, we may avoid a sluggish economy in the short run, but in our judgment they do so at the expense of continued and mounting inflation.

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Fifteen years ago, we hired Bear Stearns as the clearing firm for Sara-Bay. We think they have done a commendable job and have continued to use them. Clearing means they hold our clients' assets in segregated accounts, collect dividends and interest, issue monthly statements, act as IRA Custodians, etc. During all the disarray with Bear, the safety of our accounts was never in question. Accounts are protected by Security Investor Protection Corp., which covers the first $500,000 in equities for each account, then by Customer Asset Protection Company which protects everything above that first half million. SIPC was established in 1970 by an act of Congress. Also, Bear must keep our client accounts separate, and are not allowed to commingle funds or securities with their own assets. We will probably make the transition and use J. P. Morgan as our new clearing firm if the deal is approved, but it is likely to take several weeks or months before you see the change in your statements.

The actions of the Fed do influence our investment strategies, but there are other indicators we study, which point in a similar direction of upwardly spiraling prices. As a result, some percentage of our portfolios will continue to be invested in companies we believe will flourish during periods of inflation. Among others, these include companies that mine or distribute precious metals, and those involved in the production and marketing of natural resources. We do our best to remain vigilant as to any new energy source that may reduce our dependence on fossil fuels, but have failed to make much headway in this area. Al Gore, notwithstanding, it is our opinion that the world will continue to use petroleum, natural gas, and coal. We see no viable alternative in the next few years.

Negative news in the credit markets combined with the slowdown in overall construction has prompted some pundits to declare that we are on the verge of a recession, and others to state we are already in one. In this unenthusiastic atmosphere, the S&P 500 has already lost almost 7% since January 1st, and NASDAQ is down over 10%. Worry over the economy and the drop in stock values is having a reverse effect on us. <u>It is motivating us to look harder for values, and our interest in buying stocks is beginning to grow</u>. One more worrisome drop in the market is not out of the question, but it is the first time in a couple of years we believe opportunities are beginning to present themselves, and without excessive risk. We will do our best to find them for you. Housing markets will gradually recover, and the credit markets will begin to flow more smoothly once again. The recent actions of the Federal Reserve serve to increase, not decrease, the total amount of money in our system. Over the longer term, our markets may not have totally corrected the excesses of 1999 and 2000, but we could see a respite lasting from several months to a year or more.

Sincerely,

Mike

J. Michael Hard

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