



Regent Financial Services

Overlock Hill Quarterly – Third Quarter 2008

Where Do We Go from Here

First, we must determine what the world's economic and financial condition is now.

We know that the world economy is facing a series of new challenges and opportunities. Billions of world citizens are improving their standards of living. They are eating better, watching TV, and many are starting to drive cars. They have more freedom to build their own lives the way they want. With TV and instant worldwide communications, they see what we have – and they want it. This has led to the first worldwide boom, and created a major world problem. The growth in demand for “things” has resulted in a growth in demand for commodities that has grown much faster than the world's ability to provide new sources to supply to these demands.

I believe that it will take many years to develop new mines and oil wells to supply the world's increased need for iron ore, potash, copper, aluminum, and oil, and to build the huge numbers of electric generating power plants that will be needed to meet world demand.

This budding huge increase in demand has led to serious inflation surges in many emerging economies, and strained the established economies. In the United States, Great Britain, and parts of Europe, an increase in inflation and major slowdowns in international real estate booms are occurring.

I believe the increasing major slowdown in our real estate sector, and the very serious emerging breakdowns in Wall Street [investment banks] and our banking system may be the strong unpleasant medicine the world needs to abate worldwide inflation growth.

We in the United States may not be aware of these challenges to the world economy. Why? Because most of us are just now focusing on and beginning to understand the very severe challenges to our whole financial and real estate sectors: the *unwinding* of excesses in real estate – over-building and over-pricing, and the multi-trillion dollar financial excesses and write-offs in our financial and banking sectors. Giant, complex, new financial products, interest-only mortgages, and adjustable rate mortgages enabled millions of our citizens to buy homes they couldn't afford. Collateralized debt obligations (CDO's), a totally new credit product, where each obligation was composed of hundreds of thousands of individual mortgages, were packaged by Wall Street investment banks and sold throughout the world markets.

It was 'wonderful' as home prices rose and rose some more, then increasingly terrible as housing prices started slipping, then tumbling. The word *foreclosure* came to prominence as

mortgage delinquency rose. CDO's fell in price – mainly because no one could say what they were really worth, and then they stopped trading. Imagine billions of dollars worth of bonds not actively trading.¹ How are the hedge funds that bought huge quantities of these obligations pricing them in their portfolios? No one knows. There are no regulations on hedge funds. No annual audits, no revelation of hedging levels, no pricing regulations.

Banks and investment firms that lent billions to hedge funds to buy CDO's were similarly trapped. Starting in July 2007 with the collapse of three Bear Stearns hedge funds using 32 times leverage², followed by a three week 40% drop³ in three Goldman Sachs funds, the financial segment, which had grown to over 30% of our total economy from about 6% in 1960,⁴ really got ugly.

Multi-billion dollar write-downs by Merrill Lynch, CitiGroup and Wachovia, among many others here and in Europe, underlined the drastic problems leverage and investments too complicated to understand had caused. Then Bear Stearns, with government help, was sold to JP Morgan for \$10 a share, down from \$133.20, its 52 week high⁵. The write-downs were mainly a mystery to individual investors because the purchasers and the unfortunate owners of these institutional debt products were very quiet about their holdings. Who likes to talk about non-trading catastrophes?

The real question is: how much worse will the U.S. and British real estate markets get? Many experts state that home prices are down 14% nationwide.⁶ In California, Florida, Las Vegas and Phoenix, prices have dropped 20-28%.⁷ Many experts are predicting a further 10% or more drop in home prices in the next year.⁸ Fannie Mae and Freddie Mac, quasi government agencies, are responsible for funding nearly 70% of all mortgages in the United States.⁹ The U.S. government, through the U.S. Treasury and the Federal Reserve, has stepped in to save them, at least temporarily.

So, where do we stand now?

John Bogle, the celebrated founder of the money management firm The Vanguard Group, summed it up this way: "The banks are too big to fail and the man in the street is too small to bail."¹⁰ I believe that the real estate system, Wall Street, and the banking system have never been so intertwined before. It is a gigantic challenge to our economic system. They are all suffering at the same time with too much leverage to unwind while the price of real estate keeps slipping. It's a challenge in the trillions of dollars.

¹ Maria Bartiromo, "Facetime," BusinessWeek 18 Aug 2008: 17

² Chart: *Stearn Lesson*, "The \$2 Bail-Out," The Economist 22 Mar 2008: 81

³ Chart: *Stearn Lesson*, "The \$2 Bail-Out," The Economist 22 Mar 2008: 81

⁴ Chart III-2 "Financial Assets," The Bank Credit Analyst Mar 2008 Vol. 59 – No. 9: 24

⁵ A R Sorkin, "JP Morgan Pay \$2 a Share for Bear Stearns," The New York Times (nytimes.com) March 17, 2008

⁶ Sudeep Reddy, "Drop in Home Prices Accelerates to 14.1%," The Wall Street Journal 28 May 2008, sec. A: 3

⁷ Chart: *Housing Pain Ranges from Mild to Excruciating*, "The Housing Abyss," BusinessWeek 7 July 2008: 34

⁸ Sudeep Reddy, "Drop in Home Prices Accelerates to 14.1%," The Wall Street Journal 28 May 2008, sec. A: 3

⁹ Henry Paulson Interview with Tom Brokaw, Meet the Press, August 10, 2008

¹⁰ Gretchen Morgenson, "Borrowers and Bankers: A Great Divide," New York Times 20 July 2008

The real key, I believe, is to learn who owns all the CDO and CDS (credit default swap) packages and how they have been financed. Because hedge funds (over \$2 trillion total)¹¹ have few reporting regulations, no one knows what each individual hedge fund owns, how much mortgage debt they bought and most importantly what the real multiple of their hedge-on-hedge leverage is. The abrupt collapses of Bear Stearns and Carlyle have shown us that if you are leveraged more than 30 times, you only need to lose 3.5% of your investment to lose 100% of your principal.

My point is simple – you cannot solve a problem unless you know the size, complexity and ownership of that problem. All we know so far is the billions of dollars that banks and financial giants like Goldman Sachs, Bear Stearns, Lehman Brothers, Merrill Lynch, CitiGroup and UBS have written-off so far. We believe that the write-offs have shaken the faith of many institutional investors worldwide that have been severely damaged by fixed income CDO purchases that are rarely traded and at huge losses when they do. But, it is my opinion that many people and institutional investors are making the huge mistake of feeling that the giant CDO and CDS meltdown is over with the bailout of Freddie Mac and Fannie Mae.

If the price of housing has at least another year of falling prices and accelerating foreclosures, the damage to CDO prices and lack of trading should continue. I say this knowing the Federal funds rate has been reduced from 5.25% to 2% since September 2007.¹² But many are not focusing on the tightening of bank lending standards and rates. Floyd Norris, Chief Financial Correspondent for the NY Times reported in June, “One in four units built since 2000 are vacant.”¹³ We know that banks that use about 11 times leverage must reduce their loan portfolios by about 11% unless they can replace their equity. Most can’t.

The *Bank Credit Analyst* headlined their July 25, 2008 special report “The Super Cycle of Illiquidity, De-leveraging, and Credit Re-flation.” A fascinating point on page 2 in their analysis is, “since the 1980s, the U.S. economy has demonstrated an increasing tendency to require an ever-greater degree of stimulus to generate each new expansion.” How much longer will foreign investors put up with our spending more than we are earning? Further, a chart on Page 4 of this same issue shows, “Household debt relative to gross domestic product has risen from 63% of GDP in 1992 to over 105% of GDP in 2008. Their chart is titled “Housing Bubble and Borrowing Frenzy.” Thus, the financial challenges are to individuals as well as to the banks and Wall Street – and homeowners can’t get any more cash out of their houses by re-mortgaging.

If what I have written is correct, then why isn’t the stock market doing worse than it is? How long will it take to correct the present mess? How will the U.S. economy recover?

First, in repeating: the most important fact is that we are in a credit market bubble. Fortunately, the overwhelming percentage of individual investors don’t know what a collateralized debt obligation is. More importantly, they don’t directly own any. Thank goodness! They are unaware that globally, institutions own over \$2 trillion of these non-trading (price only) bonds and if they own other bond investments, they most likely own CDOs.¹⁴

¹¹ Chart III-2 “Hedge Funds,” *The Bank Credit Analyst* Mar 2008 Vol. 59 – No. 9: 24

¹² Federal Funds Target Rate, StockVal @, 22 Aug 2008

¹³ Marc Faber, *The Gloom, Boom & Doom Report*, June 2008, p. 4

¹⁴ “Big Hedge Funds Get Bigger,” *EUBankers.net*, 5 March 2008

So, here we are. What should we as individuals do to survive and prosper? Mortgage defaults and foreclosures have been rising rapidly. Banks earnings have severely suffered and Wall Street is in serious trouble. The American public's confidence in the health of our economy is becoming shaken. This negative attitude is reflected in the major drop in automobile sales, the length of time and drop in price to sell a house, and slow down in retail sales.

I believe there is no conviction that the flow of negative surprises from Wall Street, the real estate, and the banking system is ending. I see a continuing period of de-leveraging pain ahead for U.S. and world investors who trusted Wall Street and bought CDO's, CDS and auction rate preferreds. At this point, my best guess is that it will take another 18 months to correct itself.

The absolute key to the future, in my opinion, is making hedge fund accounting transparent. Now, no one knows how much leverage upon leverage they use. No one knows how holdings are valued. They do not get annual audited statements. It's fascinating to me that the U.S. government just watched Wall Street lend hedge funds billions and billions to buy Wall Street-created products.

Most of these products are so complex that even *Warren Buffett* says he can't understand them.¹⁵ Buyers believed these ratings. You know the rest of the story. There are now over \$2 trillion of hedge funds¹⁶ and no one knows what's in their portfolios. Why?

Mr. Henry Paulson, U.S. Secretary of Treasury and former CEO of Goldman Sachs, purportedly stated recently that there should not be any hedge fund regulations, no reporting requirements. He said in an August 10, 2008 interview with *Meet the Press'* Tom Brokaw, "Absolutely there's a lot of truth" to President Bush's comment, "It [Wall Street] got drunk, and now it's got a hangover." Paulson further said, "And in terms of Wall Street, there was too much leverage in the system and more leverage than was appropriate and more than people recognized, because the leverage came into the system in the form of highly complex, structured products, which were difficult to understand. So there is excess leverage, excess complexity." Really. And yet Mr. Paulson does not wish *any* regulations on hedge funds that bought huge quantities of these CDO's using huge leverage to do it. This is not lore. It's a fact. I believe it is absolutely imperative for our government to impose the same kind of regulations on hedge funds as on every other financial enterprise. How do I recommend this be done since Mr. Paulson refuses to recommend regulations for hedge funds?

First, I suggest the President of the United States should order two things: 1) the Controller of the Currency should order the entire bank examiner corps to identify the total amount of money banks have lent to hedge funds. I believe it would be fascinating to see how much banks have lent to each hedge fund and then total it all up. Bank examiners already have individual bank records of this type. 2) The Secretary of the Treasury should be ordered to demand that all world governments cooperate in identifying complete disclosure of hedge funds under their jurisdiction, their portfolios, their percentage of leverage used, how they price their portfolios, and immediately start filing audited statements of their finances – as every other financial entity has to do. (Read: Mandatory international regulation.)

¹⁵ Nicholas Varchaver, "What Warren Thinks," CNMoney.com 14 April 2008

¹⁶ Chart III-2 "Hedge Funds," [The Bank Credit Analyst](http://TheBankCreditAnalyst.com) Mar 2008 Vol. 59 – No. 9: 24

Then, all parties, the government agencies, the banks, and the people, will have the factual information essential to grasp the enormity of the industry, its leverage, its portfolios, and what those portfolios are worth. I believe these steps are absolutely essential to understanding the total size and complexity of the financial industry. Today, it's like trying to fix a jigsaw puzzle without a third of the pieces. You can't do it. The longer we wait, the worse the situation will become, in my opinion. And now, with the failure or takeover of Bear Stearns, Lehman Brothers and Merrill Lynch – we're still waiting for the last shoe to drop. We don't think this is the end of the road for markets instability.

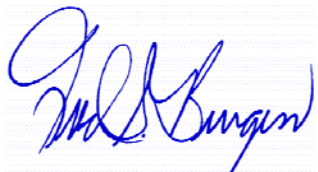
What should you do? First, clearly analyze, on paper, your complete financial situation. How many assets, free of debt, do you have? Include your real estate, bank accounts and investments. Do you have enough current income to care for your family if you can't work? How much have you saved towards retirement? Do you want to continue increasing your income above the rate of inflation? This may be the key to your future happiness.

Back to reality. Buy the kind of investments that have the un-leveraged financial strength, the pricing power in their products, the proven managements, the rising dividend records that will give you mental peace of mind as we go through this difficult economic period. No one knows for sure how long the economic challenge we are enduring will last. My best estimate is a year to a year-and-a-half. We will know more as de-leveraging continues, write-offs in finance end, transparency of corporate and financial reports improves and our nations psychology turns stronger.

We've been through the junk bond crises, the savings and loan debacle and, more recently, the tech bubble, and kept on building. We at *Regent Financial Services* are committed to the *Dividend Growth* philosophy of investing in common stocks of companies that have raised their dividends by an annual average of at least 10% for a minimum of ten consecutive years. Many have raised their dividends for 15, 20, even 30 years.¹⁷

Regent Financial Services equity investment philosophy is focused on companies that are raising dividends at an increasing rate. We believe companies do this because they see better times ahead for their businesses. We believe them.

Always the Best,



Fred G. Burgess, CFM, AIF®
Principal

September 16, 2008

¹⁷ "Longest Records of Dividend Achievement," Mergent's Dividend Achievers Spring 2008: 5a



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