

After one of the most historical weeks in U.S. financial history, one that saw the government make an \$85 billion line of credit available to AIG (in exchange for 80% of the company), Lehman Brothers file for bankruptcy, and Merrill Lynch agree to be taken over by Bank of America, the markets ended the week about where they began.

Saturday (September 20), in what would be an unprecedented government intrusion into the capital markets, the Bush administration asked Congress for unchecked power to buy \$700 billion in bad mortgage investments from US financial companies. Times are such that this may be the only way to restore confidence to the markets.

Just a month ago, the current market situation changed from a credit crisis to one of a crisis of confidence. In July, second quarter earnings from the financials were bad. Still, they were better than expected and companies were making headway emerging from this crisis. Over the last few weeks, mortgage rates for a 30-year fixed rate loan dropped, on average, from 6.2% to below 5.8%. Spreads on agency and mortgage-backed bonds (the difference in interest yield between a U.S. Treasury bond and these bonds) has narrowed back to historic norms meaning investors are again getting comfortable and gaining confidence. Washington Mutual announced their third quarter losses would be less than expected. The bailout of Fannie Mae and Freddie Mac is allowing these companies to re-enter the mortgage markets, buying loans from banks. The liquidity being infused into the mortgage market is just starting to be felt as banks are finding buyers for recently issued loans. This full impact of this process takes time to be appreciated by the markets.

All this didn't matter as investors and, surprisingly, the rating agencies lost confidence, despite the fact that 96% of mortgage holders are current on their payments. The rating agencies, such as Standard and Poor's and Moody's, which rate the credit worthiness of a company's ability to pay back their debt, lowered AIG's debt rating based on the drop in the company's stock price. The credit downgrade triggered a \$15 billion default provision on some insurance products because of provisions mandating they maintain a minimum credit quality rating. This led to a technical default even though the company itself still maintains an investment grade credit. This combined with the loss of confidence, led to the government's unprecedented involvement.

The hope is that the government proposal will strengthen the U.S. financial system and stop further meltdown. Banks will immediately have much stronger balance sheets and therefore be able to resume a more robust lending program, which is primarily how banks make money. Jobs will be created as bad loans and mortgages need to be worked out as the proposal includes the ability to hire outside companies to assist in this workout. The last time anything even remotely similar happened was the Resolution Trust Company that worked through the S&L crisis in the early 1990s. There will also be a lot of money made by those willing to take the risk of purchasing the debt from the government. As noted, the markets reacted very positively to even the notion of this plan. We will see how it reacts as the details become clearer and the plan takes shape.

The end result of this only changes the timing of our outlook not the outlook itself. We have been saying all along that we will come through this crisis with financial companies stronger and the consequence of raising additional capital will be very stimulative. When loan loss reserves are no longer growing and distressed assets revalue upward (this happens when investors are more comfortable with the economy), the banking system will have excess capital available to lend, leading to more liquidity in the market and more capital to fuel growth. As the financial crisis ebbs, the focus will return to the rapidly growing world economy and the global middle class and their new-found discretionary income. With this bailout, the recovery has moved forward and investors will be rewarded in the long run.

We are maintaining our positions in strong financial company stocks and may add to them if opportunities persist. In addition, we will continue to invest in stable companies that have strong global presence and are market leaders in their respective industries – many of which we can buy at a considerable discount. Our focus on global allocation mitigated much of the market down turn and will continue to help as confidence returns.