

If Billy Joel decides to update his 1989 hit *We Didn't Start the Fire*, there's been plenty in the headlines the last couple months from which to draw. And much of it may worry today's investor. Following the last refrain, Mr. Joel might perhaps add:

*Health care, ongoing war, U.S. dollar not worth more
Subprime downfall, Henry Paulson hears the call
Oil's at an all-time high, Chuck Prince say goodbye
Looming war in Iran, no elections Pakistan*

(Chorus)

It's said that Joel's song was a response to those who blamed his Baby Boomer generation for the majority of the world's problems. And as it has been for decades, the fire continues to burn; it's just stoked by different fans. (Insert your own cliché here.) But, as always, among the flames lies financial opportunity. There's enough going on to keep the talking-heads working overtime, but we'd like to focus on the subject dominating the conversations, line two in the suggested verse above.

Banks and financial services companies have dominated the headlines since mid-summer. And with good reason. Collectively, they have declined 21% for 2007 as measured by the Dow Jones US Financial Services Index. Not a day passes where we don't hear, see or read some news about (insert name here) taking a write-down against earnings. In essence, these firms are marking down the value of their assets that are exposed to the sub-prime market. The amount of the mark down must then be counted against current earnings.

Inferno! But opportunity, too.

In times like this, when many around are losing their conviction, it's research that makes the difference. Our job is to gather information, interpret the facts and make sound reasoned investment decisions.

The write-downs I mentioned are, on average, to the tune of fifty cents on the dollar. Some recently stretched as far as twenty-seven cents on the dollar. There is a fair chance these now depressed assets get marked back up in a year or two. The next nine to twelve months is the chance to make a lot of money in banks and financial service companies. We say this despite a fair estimate that one in three subprime borrowers will eventually default.

This situation is very similar to what we saw in 1989 and 1990. In February 1989, newly elected President George Bush announced to the American public that he would set up a program to rescue the stricken Savings & Loan industry. The announcement made plain for the first time the depth of a financial sector crisis that had been brewing throughout the 1980s and which regulators had been unable to defuse (do you hear an echo?).

Estimates of a clean-up bill of around \$30 to \$50 billion shocked US taxpayers at the time. Well, turned out that was optimistic. Today, we know that between 1986 and 1995, when the storm abated, the underwriting of US thrifts by the financial industry and the US taxpayer cost an extraordinary \$153 billion – one of the most expensive financial sector crisis the world had seen. At the time, it was universally believed that the extent of the disaster was a major threat to the US financial system. There's a place here for another *We Didn't Start the Fire* reference, but we'll spare you.

The losses were the result of unmanaged asset/liability gaps that led to interest rate exposures, speculative investments in junk bonds and service industries, fraud, and - most especially - massive losses from lending to and investing in the US commercial real estate sector. (Ever feel like life's soundtrack runs on a loop?)

So, let's try to learn from history, and combine that with our experience. In 1990, all banks were priced as though they were going out of business. Citigroup stock declined 40% in just three months from July 1, 1990 to the end of September 1990; it hit a low of \$1.39 per share on November 1 of that year. The ascension from the ashes was equally as spectacular. In the next twelve months, Citi's stock rose 73%. Over the ensuing three year period, for those that purchased the stock just prior to the drop noted above, they were rewarded for their patience and, perhaps, bravado with an annualized return of 32%.

Citigroup wasn't the only Phoenix. Its story was similar to those of firms across the US banking sector, including Wells Fargo and Bank of America.

So here we sit, with these observations:

- The major US banks will not universally be erased
- There will be more trouble and pain ahead
- The greatest opportunity is when anxiety is at its peak
- Business in the US is good, although certainly not as robust as it was in recent times
- Corporate balance sheets are very strong and will allow large companies to withstand any economic slowdown
- Citigroup, down 44% for the year, is trading at seven times 2009 estimated earnings and is valued at just one times book value.
- Washington Mutual, down 65% since the beginning of 2007, trades at ten times 2009 estimated earnings and five times 2010 consensus estimates and is currently valued at just 0.6 times book value. That means its stock is trading at less than the value of all assets minus liabilities. This is how much the company would have left over in assets if it went out of business immediately. Today, we can buy Washington Mutual, the assets plus any growth, for just sixty cents on the dollar!
- Bank of America, eight times 2009 earnings estimates and 1.2 times book value.
- Wells Fargo, ten times 2009 earnings estimates and 1.8 times book value.

Financial stocks in aggregate are trading at eight to nine times 2009 earnings expectations (notably depressed earnings expectations). Normally these companies are valued in the 12 to 15 range; meaning a 50% to 90% rise in stock prices in the next couple of years.

It is out of the ordinary for us to address you, our clients, about short-term market movements, but we heard many of you ask us about this and felt compelled to inform you of our position. I hope this short piece has been helpful. We understand that investing inherently causes anxiety and times like this only exacerbate those feelings. But through our own experience, and with history as a guide, we know that opportunities to sift through the ashes and find great reward are infrequent. We will look back at this time as one of the greatest investment opportunities of the first decade of this millennium. Burn, baby, burn.