WEDGE WATCH

A newsletter published quarterly by WEDGE Capital Management L.L.P. • January 2008

On the Kindness of Strangers

"The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite. Life is not an illogicality; yet it is a trap for logicians. It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; ***its wildness lies in wait."***
–G.K. Chesterton, English novelist and essayist known as the "Prince of Paradox" (1874-1936)

Fourth Quarter 2007
Financial Statistics

DJIA: 13264.82

S&P 500: 1468.36

90-Day T-Bill: 3.24%

30-Yr. T-Bond: 4.45%

Not long after Labor Day 1976, Hayne Leland, a 35-year old finance professor at UC Berkeley, grew restless and agitated worrying about his family's finances. As he recalls the story, "Lifestyles were in danger, and it was time for invention."

Necessity, of course, is the mother of invention and Leland had an epiphany. The professor would, as chronicled by Peter Bernstein in his uniquely insightful treatise on risk, *Against the Gods: The Remarkable Story of Risk*, "single-handedly overcome the intense risk aversion that dominated the capital markets in the wake of the debacle of simultaneous crashes in both the bond market and the stock market in 1973-1974." His objective was to develop "a system that would *insure* investment portfolios against loss in the same way an insurance company protects a policyholder from loss when an accident occurs. Insured investors could then take on the risk of carrying a large proportion—perhaps even all—of their wealth in stocks. Like any option holder, they would have unlimited upside and a downside limited to nothing more than an insurance premium. Sugarplums began to dance in Leland's head."

Leland sought out friend and fellow UC Berkeley colleague Mark Rubinstein, "a keen theoretician and serious scholar," who in a past life had traded options on the floor of the Pacific Stock Exchange. Two years passed (interspersed with a bountiful expenditure of blood, sweat and tears) at which point the duo's collaboration finally appeared to reach fruition. However, there was more work to be done. Convincing investors to employ their strategy would be the next big hurdle. Then, serendipity smiled and fortune boldly intervened - almost literally. Rubenstein put his money where his mouth was and began implementing the system with his own capital. In relatively short order, his success led to a Fortune magazine profile highlighting his investing exploits and the unique strategy he and Leland had crafted. With the help of John O'Brien, their chief marketer and an expert in portfolio theory, the professors landed their first client in the fall of 1980. They were off and running. In what seemed like the blink-of-an-eye, demand for **portfolio insurance** skyrocketed, attracting major institutions around the country. By 1987, portfolio insurance covered nearly $60 billion in equity assets (a huge sum at the time), the great majority of it on behalf of large pension funds.

If you've been around Wall Street long enough, as we have, you know beyond a shadow of a doubt that there is no such thing as a "free lunch." Portfolio insurance, despite its name, was no different. On

Continued on inside…

...Strangers

October 19, 1987, otherwise known as Black Monday, Leland and Rubenstein's brainchild faced the ultimate test – the largest one-day percentage crash in stock market history. The underlying premise of their intricate creation had been that in a declining market buyers would be there to step in and buy the stocks held by the entities that had purchased portfolio insurance. The problem was that those anticipated buyers were oblivious to the role they were expected to play (as they too were frantically selling).

As the market accelerated on the downside that fateful day, panic began to build. Amidst the chaotic sell-off, according to Bernstein's *Against the Gods,* "the managers of insured portfolios struggled to carry out their programmed sales, contributing," despite their dismay, "to the waves of selling that overwhelmed the market." When the dust finally settled, it was evident that "the dynamic programs that underpinned portfolio insurance had underestimated the market's volatility and overestimated its liquidity (sound familiar?). What happened was like a life insurance policy with a variable-rate instead of a fixed-rate premium, in which the company has the right to raise its premium as the insured's body temperature rises, degree by degree, increasing the probability of early demise. *The cost of portfolio insurance in that feverish market turned out to be much higher than paper calculations had predicted."* Needless to say, the concept, in its then current form, never recovered.

The rise and fall of portfolio insurance is a particularly vivid example of "good intentions gone awry." However, on Wall Street, intentions seldom trace their genesis to altruistic urges. To the contrary, pure unadulterated greed often drives the engine powering the trading floors; especially during extended periods of "easy money." Many decades ago Spanish philosopher George Santayana warned: *"Those who cannot remember the past are condemned to repeat it."* Charlie Munger, Berkshire Hathaway's resident curmudgeon and modern-day Santayana, has cautioned investors repeatedly, over the years, *to beware false precision.* Predictably, however, such admonitions often fall on deaf ears; drowned out by the sound and fury which permeates the NYSE. That said, *with its origins rooted in Wall Street's unfettered avarice and often misguided incentives, today's "subprime-triggered" credit cycle, itself, ironically, a by-product of initial good intentions (the dispersion of risk via securitization), continues to roll along undeterred, taking few prisoners in the process. Proof positive, once again, that not only were Santayana and Munger right, but that* ***the ghost of P.T. Barnum lives.***

The concepts of *risk management* and *margin-of-safety,* in their simplest forms, are tools of immense utility. Anyone who has ever been on an airplane that lost one of its two engines in flight can heartily vouch for that. However, *cleverness often betrays us.* The old fashioned, commonsensical approach of "saving for a rainy day" and "keeping it simple Sam" is often lost in translation (especially in the modern era of corporate governance). As Peter Bernstein elegantly points out in *Against the Gods,* "the science of risk management sometimes creates new risks even as it brings old risks under control. Our faith in risk management encourages us to take risks we would otherwise not take. On most counts, that is beneficial, but we must be wary of adding to the amount of risk in the system." Airplanes are the same way. If too much cargo is loaded on a plane, exceeding its stated weight limits, even the built-in redundancy of a second engine might prove too little of a "margin-of-safety" in the event one engine unexpectedly stalls out in flight.

Despite financial institutions throwing massive amounts of intellectual capital and computing power at the risk management equation, **the cornerstone of the financial markets remains <u>surprise</u>.** Bernstein sums it up this way, "The past seldom obliges by revealing to us when the wildness will break out in the future. Wars, depressions, stock-market booms and crashes come and go, but they always seem to arrive as *surprises*." In recent months, the integrity of the global financial system has been called into question, triggered by, amongst other things, the *financial sector's* built-up excess of subprime lending here in the U.S (this cycle's surprise "du jour"). For those of us with still-tender scar tissue, *echoes of the S&L meltdown/debacle of the late 1980's and early 1990's have begun to reverberate once again*. Then, like now, overzealous, undisciplined and unscrupulous lending led to an upward spiral of credit costs that ended with financial company stock

prices at record low valuations, and their respective balance sheets severely bruised and battered.

"I don't know what to do myself, but sometime, someone will come in with a plan that I know will work; and then I will tell them what to do."

–J.P. Morgan, speaking amidst the banking and stock market panic of 1907

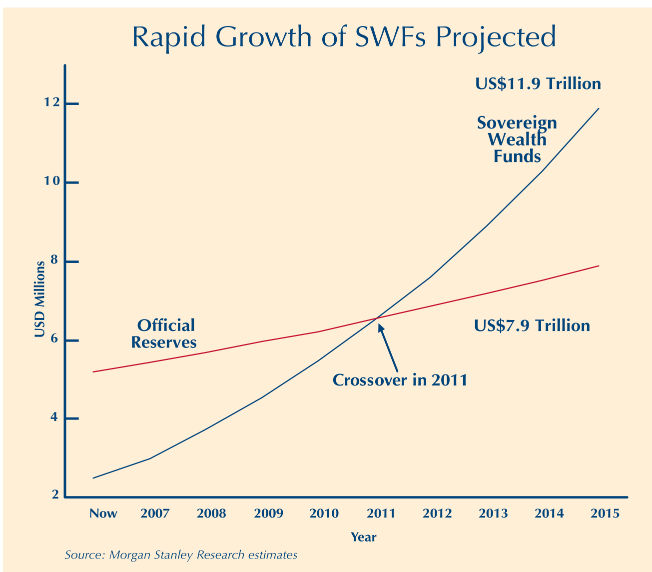
As with every credit cycle, no matter the best efforts of the Fed, damage will be done. Make no mistake, the harm inflicted on the balance sheets of banks, brokers and mortgage lenders this cycle is very *real* and the fundamental healing process will likely take several years, not several months, to run its course. Despite this still emerging credit carnage, however, **a relatively unexpected source of buoyancy has recently emerged that *may* help contain the damage,** to a degree, and allow the global wheels of commerce and finance to continue grinding forward, albeit at a slower pace. In a famous courtroom scene from the popular 1992 movie *A Few Good Men*, Jack Nicholson screams at Tom Cruise, "You can't handle the truth!" Today, though, a group of remarkably deep-pocketed investors would likely beg to differ with Nicholson's impassioned sentiment, **at a price of course.**

Over the past several weeks, we have seen foreign investors inject nearly $20 billion into two of the world's largest and most important financial institutions – Citigroup and UBS. That, in and of itself, was deserving of major headlines. However, it is what's behind those multi-billion dollar capital injections that makes for much more interesting and important reading. In the July 2003 issue of *WEDGE Watch*, we highlighted the importance of a rapidly emerging China, and what we saw as a powerful and broad-reaching story that would, in time, positively surprise investors in a big way. Today, another emerging overseas shift is afoot that may further alter the world's investing landscape, and hasten the shift in the balance of power away from Wall Street. In a recent report, Morgan Stanley trumpeted this profound development as a *"tectonic shift"* that "will have monumental implications for financial markets." To what were they referring? **The emergence of a relatively vast (and rapidly growing) long-term oriented source of *opportunistic* capital - sovereign wealth funds (SWFs).**

In the Morgan Stanley report, Stephen Jen, the firm's Chief Currency Economist (London), projected that **SWFs would "become absolutely massive in size in the not-too-distant future, having powerful implications for the financial markets."** SWFs, until recently an unfamiliar term to most investors, are state-owned funds that were set up to invest surplus funds in risky assets. At present, it is estimated that SWFs have exceeded US$3 trillion, with rapid growth projected going forward (more on this later). Many of these funds, specifically those of Middle-Eastern origin, were originally set up as oil price (or commodity price) stabilization funds to help block out disturbances, from volatile oil prices, to their respective country's budgets, monetary policy, and economy. However, "with the sharp," and possibly, "permanent rise in oil prices in recent years, the need to stabilize prices is less necessary, and subsequently these funds have evolved from 'stabilization funds' to 'wealth accumulation' or 'wealth stabilization' funds."

According to Morgan Stanley, the six largest SWFs, controlling approximately 80% of SWF assets worldwide, reside in the United Arab Emirates (the source of Citigroup's recent $7.5 billion capital infusion), Norway, Singapore, Saudi Arabia, Kuwait and China. Oil & Gas related funds account for approximately 65% of the estimated US$3 trillion total. The balance are predominantly investment funds of export-oriented Asian countries or non-oil commodity funds. Given the world's energy backdrop (increasingly tight supplies) and the on-going emergence of export-driven Asian economies, Morgan Stanley believes **SWFs have the potential to grow to an estimated US$12 trillion by 2015, a relatively staggering per annum growth rate of nearly 19% (see Chart 1).**

Chart 1



Source: Morgan Stanley Research estimates

Needless to say, even if these projections come up a few trillion dollars short, the massive size and growth of these funds will likely have consequential impacts on the world's financial markets. As we mentioned earlier, both Citigroup and UBS have tapped these sources for major capital infusions in recent months. In fact, according to a December 2007 ISI Group report, SWFs have invested US$46 billion in western financial companies since the second quarter of 2007 and we believe this trend will likely continue (especially given the current turmoil in financial stocks). In addition, G10 sovereign pension funds (excluding the U.S. social security fund) are also huge, with an estimated US$2.5 trillion of investable assets. In the years ahead, as the world's population ages (via declining mortality rates), these giant asset pools will likely begin a deliberate, and possibly pronounced, shift away from their historically low exposure to higher return assets (e.g., equities), while at the same time broadening their asset allocation away from their long embedded "home country-bias" (as the world's economies and capital markets continue to globalize). **The potential implications for stocks of highly liquid, multinational corporations should be intuitively obvious.**

The world and the global financial markets are in the midst of very significant and likely monumental change (as highlighted by the growing influence of SWFs). Beyond the China story, oil-dependent countries in the Middle East are moving very proactively to diversify their economies (this emerging reality is probably *underappreciated* by many U.S. investors). In cities like Dubai, one of seven sheikhdoms of the United Arab Emirates, the growth in their financial services infrastructure, amongst other things, is absolutely staggering (e.g., a Dubai firm recently struck a deal to acquire 20% of NASDAQ and 28% of the London Stock Exchange). Once mostly desert, Dubai today is an international business hub and tourist mecca with ambitions (and money) that would make even Donald Trump stand up and take notice. An eye-opening *60 Minutes* profile of the country (CBS - October 14, 2007) recorded Sheikh Mohammed, the head of Dubai's two-century-old ruling family, saying: "I want it (Dubai) to be number one. Not in the region, but in the world" (referring specifically to education, healthcare, and housing, not to mention finance and industry). Highlighting the radical change *apparently* afoot there is the Sheikh's publicly-stated emphasis on *gender equality* – "we are concentrating on the woman," a reference to the government's goal to make recruiting and promoting women a priority. If true, that initiative *may* signal an important shift in the direction of Western-style values within what has historically been an extremely conservative Muslim culture.

In the years ahead, if crude prices stay high, as many industry followers believe, the recycling of petrodollars into the creation of capitalistic infrastructure in the Middle East will likely continue, and possibly accelerate quite dramatically. The recent (and likely future) capital investments from this region, directed at shoring up the balance sheets of western and European financial institutions, *may*, in addition to providing much needed staying power for the respective beneficiaries, offer unanticipated and possibly profound benefits down the road: **a more fervent embrace of capitalism in the Middle East and the eventual spread of freedom and peace that it typically brings.** Given the long and turbulent history of the region, caution and skepticism are warranted, of course. However, it is important to remember that *the longest journey begins with a single step.*

Students of financial market history know that credit cycles in the banking industry have typically been triggered by excess and greed. This cycle is no different. However, the recent emergence of SWFs as backstops to capital-stressed but strategically well-placed financial institutions (who, ironically, are soliciting *the help of strangers* hat-in-hand) should ultimately give investors hope that, like all things, "this too shall pass." In the meantime, the intense pain of the moment is predictably prompting financial stock investors to succumb to fear of the unknowable, by frantically pulling the plug regardless of valuation. However, a silver lining may be in view. Amidst the credit market freeze, *the world's integrated financial system appears to be producing positive offsets by providing the sort of "lifeline," in the form of SWFs,* ***which should help prevent the fever of financial contagion from becoming tragically toxic.***

continued on outside flap…

continued from inside flap…

As stated earlier, the damage to the credit markets is very *real*. However, amidst the carnage and rubble that is emerging, ***the opportunities will be too.***

As always, we appreciate your business and continued support. Have a happy, healthy and prosperous New Year.

Index	12/31/07 Price	4th Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	13264.82	-4.5%	6.4%
S&P 500	1468.36	-3.8	3.5
Value Line Composite	440.28	-6.9	-3.8
American Exchange Comp.	2409.62	0.0	17.2
NASDAQ Composite	2652.28	-1.8	9.8

*Does not include dividend income.

Fixed Income

California Dreamin'

"All the leaves are brown, and the sky is gray…"

In the wee hours of a cold winter morning in New York City, John Phillips awakened his new bride, Michelle. He needed help fleshing out the lyrics to a song he was writing, the theme of which was inspired by *her* homesickness. A native Californian, she was having trouble adapting to the dismal, early-1963 northeast winter, and to being so far away from home. The rest, as they say, is history. A folk rock classic, *California Dreamin'* went on to become the Mamas and the Papas signature tune. A lively but melancholy song, the lyrics speak *to the longing to be some place else.*

As the winter of 2008 approaches, many California homeowners are probably "longing to be some place else," at least in a financial sense. A variety of recent news articles have detailed the plight of various homeowners who borrowed and refinanced themselves into an insurmountable mountain of debt, only to see the value of their homes begin to decline. With each story, we marvel at the tales of what, in retrospect, was throwing caution to the wind and levering up. Which begs the natural question: "what were they thinking?" Unfortunately, from the sound of it, there apparently wasn't much thinking going on at all – just some serious **California dreamin'!**

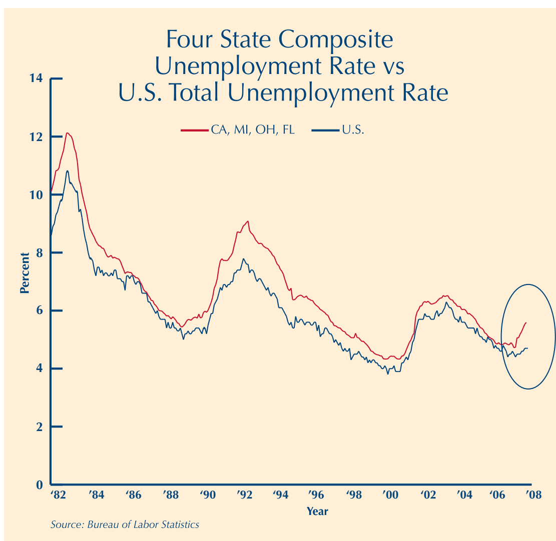
Of course, the borrowers were not alone in their pursuit of riches. As we noted in the most recent *Flash Report,* a long list of participants, each with unique motivations and incentives, drove the housing excesses of recent years. And we certainly don't mean to imply that Californians are the only ones who participated in the excesses – far from it. But it is instructive that, according to *The Wall Street Journal*, several California metropolitan areas have among the highest mortgage delinquency rates, along with home prices well above the national median.

continued on back cover…

continued from outside flap…

Many are hopeful the housing sky may turn out to be less gray if overall **employment** holds up. This notion is central to those who believe the housing bottom is near. After all, even more frugal borrowers need a steady source of income to service debt. With that in mind, we decided to take a look at trends in some state-level unemployment rates relative to the national average, which somewhat surprisingly, has held up well so far. What we discovered, however, may cast doubt on the sustainability of that trend. And just to show we aren't unfairly picking on California, we included a few other states (Florida, Michigan and Ohio) that have shown relatively high mortgage delinquency and foreclosure rates. **Chart 2** shows the monthly unemployment rates for a composite of California, Florida, Michigan and Ohio, as well as the national unemployment rate. Note that there appears to have been a fairly sharp upturn in the four-state unemployment rate composite, relative to the national average, in recent months. Might this be a harbinger of things to come across the rest of the country?

Chart 2



There are a number of other items that suggest the housing recovery will take some time to arrive. For example, the availability of home mortgage credit has been significantly reduced. In addition, lending standards have sharply tightened while the supply of homes on the market now exceeds 10 months (at the current sales pace). For the market to clear, it seems evident to us that home prices will likely continue their descent for at least the intermediate term (if not longer). On the other hand, the good news is that markets do work over the long term. In fact, in recent months, risk has been repricing. Going forward, we expect this trend will continue.

In 2007, our more conservative tilt in fixed income portfolios rewarded us. As 2008 unfolds, we expect the recent upsurge in credit spreads and interest rate volatility to remain intact, just as we expect that housing/subprime issues will continue to affect the economy and capital markets in **unexpected ways.** Stay tuned.

This information is not intended as investment advice or a recommendation to purchase or sell specific securities. These opinions may change at anytime without prior notice. While every effort has been made to verify the information contained herein, we make no representation as to its accuracy. Index and commodity changes are based on price-only percentage change. It is not possible to directly invest in an index. Past performance does not predict future results. All data presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Company names are used for illustrative purposes only and should not be construed as a recommendation to buy or sell any financial securities. There is no guarantee that any forecasts or opinions expressed in this material will be realized.

Written by J. Scott Jeffords, James F. Walters, and Bradley S. Fisher of WEDGE Capital Management L.L.P.

301 South College Street, #2920, Charlotte, NC 28202-6002 (704) 334-6475 www.wedgecapital.com