

### Moral Hazard, Anyone?

September was a month of two halves.

The first half saw continuing volatility and downwards pressure on equity markets, with the credit crunch snagging its first major victim in the UK. Northern Rock, the fifth largest British bank, was the victim of a bank run, the first seen in the UK since the 1860s. Concerns over the bank's solvency caused depositors to queue to withdraw their funds.

Northern Rock had pursued an extremely aggressive strategy of increasing its share of the mortgage market, loaning out as much money as possible. However, its Achilles heel was that it did not have a huge number of depositors who were providing the funds for its mortgage lending – it was obtaining these funds by borrowing in the market. This strategy worked perfectly well whilst banks were willing to lend, but once the sub prime crisis hit, no one knew which institutions were going to be worst hit – which were holding assets that would turn out to be worthless. Therefore, unable to assess the risks of lending to their peers, banks either stopped lending completely or massively upped the rates they were charging.

Northern Rock's entire strategy rapidly became untenable. Once depositors became concerned about the safety of their money, they were faced with a version of what is known as the 'Prisoner's Dilemma'. If no one withdrew their funds, the bank would survive and everyone's money would be safe. But if depositors took out their money, the bank might fail. If this were going to happen, only those that withdrew their money early would be safe. There was a rush to withdraw. Queues snaked around the block. The panic only eased once the Bank of England announced that it would guarantee all deposits, going far beyond the legal deposit protection that was already in place.

Everything changed on September 18<sup>th</sup>. The US Federal Reserve, faced with a raft of figures showing that not only was the housing boom well and truly over, but that more than a million families could lose their houses, dropped the overnight interest rate by 0.5% to 4.75%. Markets soared and were quickly hitting new highs. There had been impassioned pleas to protect US home owners from the brutality of the markets. Forget that up to 50% of sub prime borrowers were said to have lied about their incomes so as to secure mortgages they couldn't really afford. Forget also that many of the houses that were bought had been bought by speculators looking to flip properties rapidly for a quick profit. The Fed was prepared to ride to the rescue. The message? Take risks – take on debt – the Fed will bail you out.

But the pain may merely be delayed. One of the criticisms levelled at Alan Greenspan was that, by being ready to drop rates whenever markets faced turbulence, he encouraged investors to take more and more risk. Money was too cheap, people kept taking on debt, excesses built up and bubbles (techs, media and telecoms in the late 90s, property since 2000) inflated. Bernanke may be following the same approach. Any eventual reckoning will be far more unpleasant than it might have needed to be. Whilst markets may have shrugged off their worries for now, a vast number of mortgages that were sold in the US over the last few years on a variable rate will 'reset' in 2008, with already troubled homeowners facing much higher interest rates. We have not yet heard the last of sub prime.

## Lowes Wealth Management September 2007 - Performance Update

The LWM portfolio returned 3.39% for September, taking our total performance to 62.24% since launch in October 2005. The best performing markets were (not surprisingly) the Dow at 4.03% and the S&P at 3.58%. The DAX returned 2.92%, the FTSE 2.59%, the Nikkei 1.31% and the CAC 0.94%.

Our best performing stocks for September were Aero Inventory (24.25% - UK), Posco (16.61% - Asia), Chesapeake (9.30% - US) and Munich Re (6.3% - Europe). Our worst performing stocks were Persimmon (-16.68% - UK), Fremont (-13.33% - US) and Latecoere (-12.50% - Europe). All Asian stocks were positive.

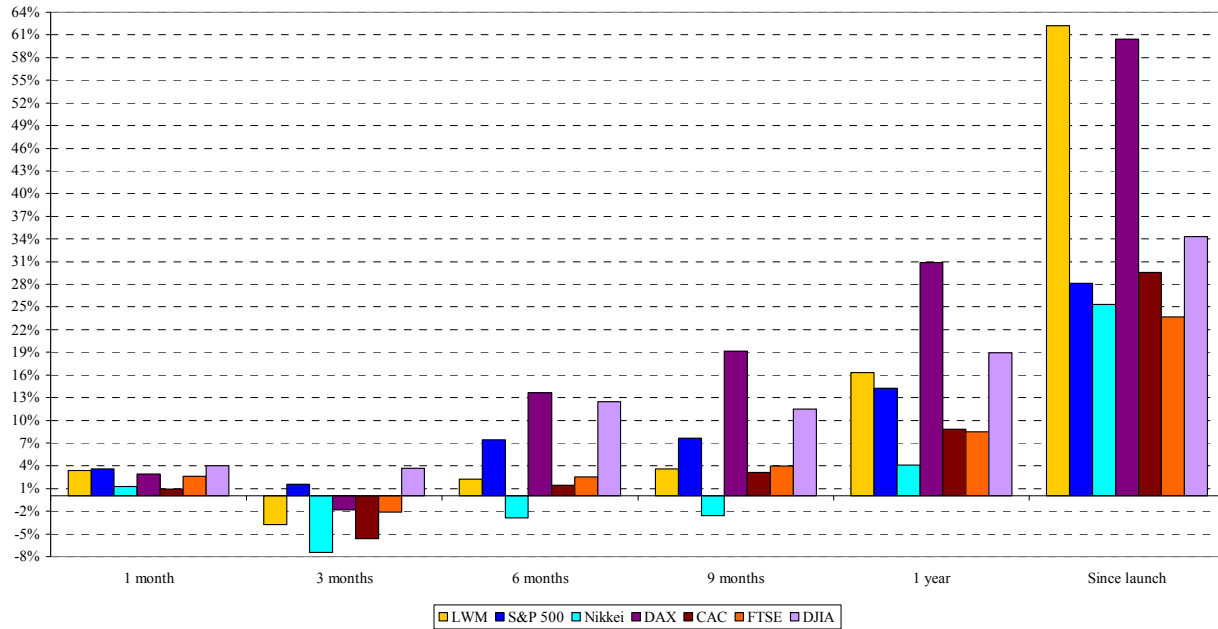
At LWM we operate according to a strict value-based investment methodology. We focus on undervalued tangible assets, established companies and strong dividends. By purchasing companies at a substantial discount to their intrinsic value, we reduce risk and maintain the possibility of generating superior returns. Since launch we have outperformed all major markets, with a below average level of volatility.

Please forward this to any friends or colleagues for whom you feel this may be of interest. If this has been forwarded to you and you would like to receive monthly performance updates, please let me know.

Kind Regards,  
Justin  
[www.loweswealth.com](http://www.loweswealth.com)

## Lowes Wealth Management – September Performance Report

Performance as of September 28, 2007



	LWM	S&P 500	Nikkei	DAX	CAC	FTSE	DJIA
1 month	3.39%	3.58%	1.31%	2.92%	0.94%	2.59%	4.03%
3 months	-3.77%	1.56%	-7.46%	-1.82%	-5.60%	-2.14%	3.63%
6 months	2.21%	7.45%	-2.90%	13.65%	1.45%	2.52%	12.48%
9 months	3.58%	7.65%	-2.56%	19.17%	3.14%	3.95%	11.49%
1 year	16.35%	14.29%	4.08%	30.93%	8.87%	8.49%	18.98%
Since launch	62.24%	28.15%	25.31%	60.41%	29.53%	23.70%	34.32%

### Key

- LWM – Lowes Wealth Management
- MSCIW – Morgan Stanley Global Index
- S&P 500 – US Standard and Poor's Index
- FTSE – UK Index
- DAX – German Index
- CAC – French Index
- N225 – Japanese Nikkei Index

**\* An explanation of how we derive our performance figures.**

The performance figure that we quote is the total return on our entire equity portfolio. Thus, it measures the performance of all stocks that we actually own on behalf of our clients. This is a gross return (no charges are calculated) and is expressed in US Dollars. (Which is the currency most commonly invested by our clients.). We measure only the performance of the equity that we hold – we do not factor in any cash that is held. (Which will tend to dilute performance when our stocks rise in value, but dilute losses when our stocks fall.).

Whilst this is, therefore, an accurate indication of the performance of the stocks that we hold on behalf of all our clients, each individual clients' returns will be different due to charges, the cash that we hold on their behalf, depending upon when they invested and in which currency.

Please note: As always, I've tried to ensure that this will go out only to those who will be interested in this information. If you don't want to receive this in future please let me know and I'll take you off the list immediately

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*Stated performance reflects equity gains, exclusive of any fees.*

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