

**The Credit Crunch - Anatomy of a Crisis -
Is there Light at the End of the Tunnel?**

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Introduction

As the worst of the crisis has unfolded, we have been largely unaffected. We have been holding more than 90% of our clients' assets in cash for some time.

We believe that the circumstances are now in place that will enable investors who employ strict value investment criteria to identify and gradually invest into select high-quality companies at prices that, when viewed with the benefit of hindsight in years to come, will be recognised as once-in-a-lifetime investment opportunities.

We're not saying that markets have necessarily hit bottom, nor are we saying that we want to rush in and commit 100% of our capital straight away. But the circumstances are ripe for those who can stand aside from the herd mentality and selectively step in, one company at a time, to accumulate shares in superb companies that are likely to vastly outperform in the future.

In this comprehensive overview of the crisis, we attempt to explain in an accessible way how the credit crunch developed and why the latest approach adopted by the British, European and US governments is likely to finally address the crisis of confidence that has paralysed credit markets.

Executive Summary

The chaos and volatility is likely to continue for the foreseeable future. Financial institutions and households will need to continue to deleverage which will maintain downwards price pressures on numerous asset classes and upon consumer spending. But government interventions, in the form of injecting cash into ailing banks in return for an equity stake, are likely to finally ease the entwined crises of confidence and credit that have created an appalling vicious circle and have led to fears of a global depression.

This likelihood of success has not yet been fully appreciated by the markets and ongoing announcements of bad news (of which there will be many more to come) will continue to engender tremendous fear and volatility. The panic that has ruled over the last few weeks has caused huge swathes of companies to be marked down in price, leading to a number of superb companies for which there is no real existential threat being marked down to unbelievable prices.

Opportunities to buy into such companies will regularly arise whilst the fear persists. But at the same time, many seemingly undervalued companies are in reality booby-trapped. Caution is required and in-depth fundamental analysis is essential. A gradual accumulation of high-calibre companies based upon strict value investment criteria will enable investors to take advantage of opportunities that come along very rarely and will lay the ground for wonderful investment returns in the future.



Part 1: Causes

In the Beginning...

All was well with the world. After the dot-com bubble burst in 2000, aggressive attempts to stimulate the economy by central banks had resulted in interest rates that were negative in real terms and encouraged consumers to spend, whether or not they had any money. Ever increasing house prices meant that homeowners could continually increase their debts, safe in the knowledge that the increasing equity in their homes was sufficient to offset their exposure to credit.

At the same time, ever increasing house prices represented an easy road to riches. Those that could get the credit were often tempted to buy additional investment properties with small deposits on the grounds that where was the risk? Those that couldn't get the credit realised that a lack of financial resources or a steady income needn't bar them from getting on the gravy train, so they just lied on their applications and got the credit anyway.

The demand for housing prices and the increasing wealth that was created encouraged all participants in a seemingly effortless virtual circle. Construction companies increased supply as fast as possible. At the same time, massive amounts of consumer expenditure on the back of raising home prices, plus the optimism that all of this engendered, stimulated demand throughout the economy and helped to push up equity prices around the world.

A Lack of Political Leadership

Everything was going up and life was good. Greenspan was the most successful central banker of all time and Bernanke was even more focused on letting the markets do their thing. Inflation was tamed. Indeed, in the UK Gordon Brown had even managed to abolish the boom and bust cycle, which was awfully nice of him.

But in reality, politicians and central bankers held interest rates far too low for far too long.

Property prices rose dramatically out of line with their historical values in major and emerging markets including the UK, US, Australia, Ireland, Netherlands, Spain, France, China, Singapore and Hong Kong. In all markets, this time it was different. In the UK, limited space for building houses, increased immigration from Eastern Europe and a rise in the number of households due to the rise of the single-parent family all meant that prices would go up forever. The credit-fuelled consumer spending boom led to debt levels for British households reaching 169% of their disposable income. In the US, household debt was a more modest (but still frighteningly high) 140%. In Iceland, a poster economy for many, debt levels reached 213%.



Falling Standards in the Mortgage Market

Before, of course, the bank manager reviewing the mortgages would have recognised that many of the applicants were not being entirely truthful about their incomes on their mortgage application forms. But the traditional role of the bank in the community had disappeared.

In this brave new world, mortgages were originated by agents, then sold on as quickly as possible. This meant that the risk of default was not borne by the person that sold the mortgage, provided he could sell the debt on quickly. Mortgages were often sold on several times so that the owner of the debt rarely had any conception of the circumstances of the person who owed them money. If you were paid a substantial commission to sell a mortgage, but weren't liable if the mortgage went bad, why should you care whether or not the person could afford to pay?

In the rush to sell as many mortgages to as many people as possible, the nature of the mortgages themselves began to change. Whereas in the US fixed-interest mortgages had been the norm, now more flexible and exotic Adjustable Rate Mortgage (ARM) products, which magically lowered the bar for house purchases, began more and more to dominate.

Some of the real gems included negative amortization mortgages, where the monthly payments for an initial period were not sufficient to cover the interest (let alone the repayment of the capital!) and the shortfall is added to the outstanding balance, leading to a sharp increase in repayments once the initial period is over; as well as NINJA mortgages, designed for those with No Income, Job or Assets!

For anyone with eyes to see, creating mortgages for people whose ability to pay was entirely dependent on substantial capital appreciation, the top of the market had to be near.

These new products enabled mortgages to be sold to people with increasingly shaky financial situations. In the US, the safest borrowers were classified as "prime". "Alt-A" were more risky and "sub prime" were the riskiest of all. The percentage of mortgages being sold to sub prime borrowers boomed dramatically as the property market neared its peak. A later investigation suggested that as many as 50% of sub prime mortgage applicants had lied on their applications.

What does CDO mean?

But all of this didn't really matter. Clever people in investment banks realised that groups of mortgages could be aggregated then sliced up and sold onto investors far and wide. The logic was that by combining many different mortgages, then selling them on so that the purchasers only had a tiny piece of exposure to each individual loan, the risks of holding the asset would be minimal. After all, even if a few loans became delinquent, not everyone would start to default at the same time?

To illustrate how this works, let's take a highly simplified example. Imagine that 3 households take on identical mortgages. The payments for each household are \$500 per month and these assets (if a bank makes a loan it is an asset as the bank will receive an



income) are owned by the bank, which then puts them up for sale. If, as an investor, you decide to purchase one of these assets, you would receive a \$500 income as long as the mortgage is being paid. But if the mortgage turns bad, you could lose all of your income.

But if these three mortgages are combined then they can be divided and sold into slices with different levels of risk. (We'll assume 3 slices with identical levels of income to keep things easy.). Each slice then pays \$500. But the total income off all three mortgages can be used to pay each slice in order. Slice 1 (the least risky) gets the first \$500 that is paid. Then slice 2, then slice 3 (the most risky). If any of the households fail to make their payments, the full cost is borne by slice 3. If more than \$500 in payments is impaired, then slice 3 pays no income and slice 2 also starts to get hit. Only if more than \$1,000 in payments is impaired does slice 3 start to suffer.

The loans were combined and sliced into “tranches”. Depending on the seniority of the tranche, these “Collateralised Debt Obligations” (CDOs) were given investment grades ranging from “junk” to “AAA” by the ratings agencies such as Standard & Poor’s and Moody’s Investors Service. AAA is the highest rating possible and implies that the CDOs were as safe as US or UK government bonds. If the loans contained within the CDO started to sour, the highest risk grade tranche would suffer first. The senior tranches would be the last to suffer any impairment and a lot of mortgages had to go into delinquency before they were affected, hence the view that they could be worthy of the AAA rating.

Strangely, no one seemed to mind that it was the investment banks who were selling the CDOs that were paying the ratings agencies to rate the CDOs. This created a clear conflict of interest. Ratings agencies made a fortune off providing ratings for CDOs created by investment banks that then, in turn, made a fortune selling them on to institutions and individuals far and wide. The implicit (or perhaps explicit) threat was that if a ratings agency wasn’t prepared to award the senior tranches a AAA rating, perhaps another rating company would be more accommodating for both current and future business.

How the Banks Got Themselves into Trouble

Many institutions are limited to only buying assets rated as AAA for a part or all of their investment portfolios. And also, carrying AAA assets provides the most benefit for financial institutions in terms of their Capital Adequacy Ratios. (This is a measure designed to ensure that bank lending remains within prudent limits. More and higher quality assets enable a bank to lend more and therefore make more profit.).

Once the investment banks started to churn out large quantities of AAA rated CDOs that paid a significantly higher income than AAA government bonds, few thought to questions that the assets might not be as safe as the AAA stamp suggested. Demand was huge. Supply was not a problem as the amount of mortgage debt outstanding kept rising and rising.

Banks were voracious buyers and sellers of CDOs. Many of the CDOs that they sold carried guarantees that the bank would reimburse the purchaser to make up for any losses should the underlying loans start to turn bad. To make things far more confusing, they moved a lot



of these into off-balance sheet vehicles (made infamous during the Enron collapse) that enabled them to reduce their disclosure requirements and be more creative with their lending. This means that information on the amount and nature of the CDOs was not made readily available and a full appraisal of the assets and liabilities held by the bank was very difficult, if not impossible, to make. This practice was a key factor in the subsequent collapse of a number of banks.

On top of this, continually rising asset prices led banks to believe that they could keep lending more and more to households as, on paper, the households' financial positions looked strong. As well as mortgages, they provided loans to buy cars, credit card accounts and home equity lines of credit (which is basically an overdraft facility that is available to the consumer to use as they wish and which is secured on their property). All of these loans looked solid enough as they were backed up by the equity that the consumers had in their properties.

Increasing Leverage

Leverage (or gearing) is the use of debt to increase levels of investment. A consumer who puts down a 10% deposit on a property and takes a 90% mortgage has effectively leveraged their deposit by a factor of 9.

The years running up to the credit crunch had been marked by an incredible absence of volatility in asset prices. They just kept going up. At the same time, inflation seemed to have been tamed by the central banks.

As a result, financial institutions, companies and consumers started to underestimate levels of risk. The "spread" on risky assets (this means the premium that a risky asset must pay the holder to compensate for its increased risk over, say, a US treasury bill) fell to historic lows. In a world of low volatility and no apparent risk, many financial institutions and companies (plus of course consumers) took on more and more borrowings in order to invest in supposedly safe assets.

With seemingly easy pickings on offer, US investment banks began to trade vast amounts of their own capital alongside the hedge funds that they served. In chasing profits they leveraged this capital, often at a ratio of more than 30:1. This meant that for every \$3 they invested, they would borrow another \$90 or more. In effect, they had become giant leveraged investment funds themselves. It was almost impossible to assess the risks they were taking in generating their vast earnings given the amount of leverage, the opacity of the instruments in which they were investing and the complexity of the system as a whole.

Many "normal" companies were also in a position where a high percentage of their revenue was coming as a result of their financial operations. General Electric and General Motors were two examples where it was the financing arrangements they provided to their customers to buy their products, rather than the products themselves, that appeared to be the main contributor to their income.



During benign economic conditions, high leverage enables high profit margins. If a home owner puts down a 10% deposit to buy a £200,000 house, and that house increases by 50% in value, their equity in the property (obviously this is a simple example!) has increased from £20,000 to £120,000.

But in bad times, high leverage rapidly leads to losses. If the home owner puts down that 10% deposit but the price of the property falls by only 10%, the entirety of that homeowner's £20,000 equity has been wiped out.

Credit Default Swaps?

At the same time as CDOs were being created and sold on as fast as possible, many banks, insurers and hedge funds were getting heavily into Credit Default Swaps (CDSs). These are a way to insure against a company becoming unable to pay its debts.

CDSs were originally conceived as a way of hedging against risk. If you were going to lend money to a company, you could then buy a CDS that would pay out if the company defaulted on its obligation to repay. This was a sensible measure to reduce the overall risk of your lending operations. (Indeed, both CDSs and CDOs have legitimate applications – it's just that both have been prone to abuse.).

But CDSs became a means of speculation in their own right and the value of CDSs quickly came to dwarf the value of the debt that they were designed to insure. The market had grown so vast that the notional value of all contracts was in the hundreds of trillions of dollars. (In practice, the net value of the existing contracts would be much lower as many of the contracts would offset each other.).

Certain institutions were particularly involved in these markets. For example, Bear Sterns alone was counterparty to some US \$35 *trillion* in CDSs. Many of these contracts were written "off exchange". This meant that it was a contract created between two institutions and information about the contract was not available on a recognised exchange. It was therefore very difficult to know exactly what CDSs were out there, who was the counterparty and who would be liable should companies start to go bust. Financial institutions and hedge funds would be in a situation where their trades were no longer hedged until the chaos following such a bankruptcy could be resolved. The staggering complexity of this situation was a major factor in the paralysis that later developed as companies were simply unable to work out the level and location of risk.

Whilst some institutions speculated with CDSs, some institutions spotted a way to make seemingly easy money by issuing them without significantly offsetting their exposure. For example, AIG, then the biggest insurer in the world, made a fortune by writing insurance on the debt of some of the largest financial institutions in the world, particularly Lehman Brothers, one of the big US investment banks.



The Mismatch of Assets and Liabilities

Virtually all of modern finance is based on an “Emperor’s new clothes” confidence trick. A £50 note only has value if other people believe it’s worth £50. It is not backed by any physical asset. (Only the Swiss Franc is still backed by gold.). Once confidence disappears, what are assets really worth?

Banks take deposits and lend them out. They have to keep a certain level of assets on hand but are free to loan out the rest. This means that they will only have a small percentage of depositors’ funds available at any one time to satisfy withdrawals. And because many of the loans that they make are long term (e.g. mortgages) but their deposits are on a short-term basis, they suffer from a mismatch of long-term assets and short-term liabilities.

In normal times, this doesn’t matter. But if doubts about a bank cause depositors to queue up for their money, the bank will quickly be unable to meet its liabilities. The upshot of this is that NO bank can survive a catastrophic loss of confidence that leads to a prolonged bank run. Even if the bank wanted to sell all of its assets to meet demands from its depositors, it would be unlikely to be able to do so given the long-term nature of most of its lending. And even if it could, it would be mounting a fire sale of assets that would undoubtedly fetch lower prices.

Some financial institutions were more vulnerable to this than others. Lenders such as Northern Rock in the UK and Countrywide Financial in the US had aggressively carved out a large share of their mortgage markets, whilst only having a relatively small pool of deposits on which to draw. To cover this, they would rely on the credit markets for short term funding, turning over loans on a regular basis to keep them liquid enough to provide the long-term loans to their mortgage clients. This business model was aggressive but seemed to work well enough assuming that the credit markets would continue to function normally.

US investment banks, although operating a very different business model, were in the same boat. Unlike US commercial banks they had no depositors and so were very vulnerable to any disruption in their ability to secure financing from the credit markets. They also depended for a great deal of their income on their status as “prime brokers” for hedge funds. Although hedge funds only control about US \$2 trillion, they are heavily leveraged and often trade extremely rapidly using computerised models that buy and sell positions in fractions of a second. Their trading fees were thus a critical revenue stream.

Mark to Market

In late 2007 new accounting rules came out in the US which required financial institutions to price their assets according to the value they would fetch in the open market. This was designed to force institutions to more accurately report the values of their assets.

What was not fully appreciated was that in times of extreme volatility in asset prices, if there were no ready buyers for an asset, the banks could be required to massively write down the



value of assets to reflect the fire-sale price that they could expect to receive in such circumstances.

A dramatic collapse in the price of widely held assets would therefore depress banks' asset values (even if they had no intention of selling the assets and anticipated that they would recover their value in the future). This would then affect their ability to loan money as banks have to hold a certain level of assets to support a certain level of lending. For example, if a bank has to hold 8% of assets in comparison to its lending, then every £1 drop in the value of its assets means that it must reduce its loan portfolio by £12.5. Should there be a dramatic collapse in the price the market was prepared to pay for assets, *even if those assets were in essence sound and the bank had no intention of selling into such a market*, the bank would have to mark down the value of the assets and reduce its loan portfolio by a factor of 12.5 times the write down.

This meant that dramatic falls in the price of bank assets could hugely affect the ability of banks to provide credit. And a large scale withdrawal of credit at a time of economic difficulty could dramatically escalate the scale of any problem.

Part 2: The Crisis Unfolds

House Prices Begin to Fall

In 2006, house prices in the US *<gasp> stopped going up.*

This unthinkable event had to happen because everyone who could afford a house (and millions who couldn't) had already purchased at least one. Added to this, the construction companies had been desperately increasing supply to match escalating demand. But it takes time to purchase and develop land, so the construction companies were always lagging the market.

A flat market and dramatically increasing supply could only mean that prices would begin to fall. As they did, the most marginal of buyers quickly fell into a position of negative equity (where the value of the loans outstanding on the property is greater than the value of the property itself). These buyers, many of whom had put down no deposit and who had no assets to call upon and no way to repay the loan, quickly began to walk away from the properties. At this time, the phrase "jingle mail" was coined as the erstwhile property owner simply mailed the keys back to the bank.

Supply continued to come onto the market, exacerbated by increasing levels of houses becoming empty as a result of foreclosure. This began to accelerate the decline in property prices. What started as a mild decline quickly developed into a rout. Each further fall in prices put more homeowners into negative equity, thereby increasing their reason to simply stop paying the loan. Each rise in foreclosures added to the already oversupplied markets, further dampening demand. Those that wanted to buy started to read the signs and, even if



they could afford to buy at the new prices, decided to sit on the sidelines until price falls declined.

Demand collapsed and, with every fall in prices, the amount of supply increased.

As well as in the US, a similar story was unfolding in many other economies, including the UK (which was perhaps 6-12 months behind the US in the cycle), Ireland, Spain etc.

Early Indications of Trouble in Financial Markets

In February of 2007 HSBC announced that it was writing down US \$10.5 billion relating to sub prime CDO investments in the US. Then a number of hedge funds that had been speculating on CDOs blew up in the summer of 2007. Confidence in mortgage-backed CDOs quickly began to evaporate and financial institutions began to question the sustainability of companies such as Northern Rock and Countrywide Financial. As soon as doubts emerged about their business models, they were hit by a multi-pronged assault that destroyed their businesses in a matter of weeks.

1. They relied on selling mortgage products to survive. But the market was drying up quickly.
2. As they did not have a lot of money from depositors they relied on short-term debt to cover their liquidity requirements. But who wanted to provide liquidity to these institutions for a modest rate of interest if there was any doubt about their ability to repay?
3. In Northern Rock's case, rumours about its viability, plus confusion over the UK's deposit protection rules, led to a run on the bank, with depositors queuing up to withdraw their money before the bank went bust. And by rushing for the exits, the depositors sealed the fate of the bank, which was eventually nationalised by the UK government.

CDO-related write downs in the hundreds of billions of US dollars began to be booked by banks and institutions from around the world.

The Vicious Circle

The crisis accelerates.

As the housing market worsens, more and more loans become delinquent and more and more CDOs start to sour. Previously a vibrant market, liquidity and demand for CDO products falls through the floor. Given that there are no buyers for CDOs, the banks have to mark the CDOs they hold to the price that the market is willing to pay (not much). They start to book large write-downs in the value of these assets. As a result, they have to restrict their lending to preserve their Capital Adequacy Ratios. And because their loans are leveraged on the value of their assets, for every pound that they lose in assets they have to restrict their lending by a considerably greater amount. But as banks restrict their lending, even those



who are solvent and wish to buy a house find it harder and harder to obtain the mortgage. This puts further downward pressure on house prices, which means that more people go into negative equity, more loans foreclose and more supply comes onto a market which is already saturated and in freefall.

At the same time, banks are terrified of running out of money and seeing their business destroyed by a run on the bank or a failure to obtain short-term funding. They cannot see where the crisis will lead, so they begin to hoard money. Because banks have exposure to CDOs and CDSs, that are virtually impossible to value, *and this is greatly exacerbated because many of these assets have been held off the balance sheet so as to allow banks to be more creative and provide less disclosure.* Banks cannot assess the business risk attached in the short term to their fellow financial institutions. Indeed, they cannot even accurately assess their own credit risk!

Banks don't want to loan to and can't borrow from other banks. So they sit on cash desperate to save themselves. But in so doing, they choke off the supply of credit that is required by other companies and imperil the whole system.

Major Institutions Begin to Implode

Central banks desperately try to pump liquidity into the system to encourage banks to lend. This often has a short-term impact but any piece of bad news (and bad news is starting to come thick and fast) causes the banks to reduce lending again. Central banks start to accept more and more dubious assets from the banks in return for providing them with liquidity.

But events are moving too quickly. Rumours swirl about investment banks in the US being on the verge of bankruptcy. They are so highly leveraged that any small loss is multiplied, often 30 times or more, which could quickly wipe out the investment bank's entire asset base.

Hedge funds, worried about being exposed to an investment bank that goes under, start to take their business away from the most vulnerable banks. This deprives them of a huge part of their income and makes their demise more likely. They cannot access money in the short-term markets and even the US government opening its credit facility to troubled investment banks provides only a limited reprieve. Tens of billions of dollars of client funds walk out of the door of Bear Sterns which collapses in a matter of hours. The US government arranges for JP Morgan Chase to purchase the bank at less than 2% of its previous highest share price in order to prevent the financial system from suffering further meltdown. Bear Sterns had more than 100 years of history.

After Bear's demise, things seem to quieten down. Had markets hit bottom? But the fundamental factors driving the credit crunch are still in operation. House prices continue to fall. Unemployment starts to increase. Consumer spending on "big-ticket" items such as cars declines dramatically. This spreads the pain more widely throughout the global economy. Credit is still restricted as no one wants to risk lending at anything other than punitive rates.



Rumours persist that Lehman Brothers is in trouble. That the government sponsored mortgage entities Fannie Mae and Freddie Mac (that between them are responsible for more than US \$5 trillion in mortgages) are not sustainable. In a short space of time the US government is forced to nationalise Fannie and Freddie, Lehman is allowed to go bankrupt and AIG blows up due to its insuring the debt of the likes of Lehman. Merrill Lynch is sold to Bank of America (which also purchased Countrywide Financial) for a snip of its previous value. Washington Mutual declares bankruptcy and is sold in chunks to JP Morgan Chase, followed by Wachovia which is acquired by Citigroup. Morgan Stanley and Goldman Sachs, the two remaining major investment banks, agree to change their status and accept more regulation in return for greater support from the US government.

In the UK Bradford & Bingley is nationalised and in Europe rescue packages are hastily assembled for Fortis Bank, Hypo Real Estate and Dexia. Iceland turns from paragon to pariah. Its economy completely disintegrates and all 3 of its major banks are nationalised. Political leaders declare the country bankrupt.

Global share prices collapse. The credit crunch looks to be transforming into a credit freeze that could choke the life out of any company that is dependent on securing short-term financing. In 8 days major global markets fall 20% - 40%.

The world stares down the barrel of a depression rivalling that of 1929.

Part 3: A Workable Solution?

The US Federal Reserve has been frenetic in its attempts to address the crisis. A US \$700 billion bailout bill was signed with an initial focus on purchasing the toxic assets from the banks so that confidence and lending would resume. But markets did not appear to applaud this move. Even a coordinated round of interest rate cuts failed to enthuse investors who seemed to be interested only in finding the safest mattress under which to invest. Less well-publicised efforts, such as a loosening of mark to market rules, also failed to inspire.

But last week, amidst the chaos, the British government announced what appears to be the best approach yet in tackling the crisis. Echoing recent deals by Warren Buffett, this involves investing up to £50 billion in capital directly into banks in return for preference shares, thus providing drastically needed capital. It will also provide up to £200 billion in bonds so that banks can swap their most illiquid assets, and up to £250 billion to guarantee short-term loans taken out by banks. This means that it will dispel the fear about short-term lending that has been a key driver of the credit crunch as these loans are now backed by the government.

A partial nationalisation of the banking system would have sounded preposterous a few years ago, yet now seems the best way to instil confidence and enable the banking system to function properly again. After all, to keep the banks afloat, the government always has the option to simply print more money and increase its stake, therefore providing additional



capital. The very real danger appeared to be that if confidence completely evaporated, a total freeze on bank lending would not only lead to far more banks going down, but would also devastate ordinary companies that relied on access to debt to be able to function.

Whilst the numbers involved sound huge, this could in fact be a very profitable investment. If the confidence that government support provides is sufficient to keep the banks alive, then the prices paid for the preference shares are likely to be seen as bargains in years to come. Whilst it is difficult to know what value the government will get for swapping treasury bills for some of the banks' least attractive assets, the assets will have at least some genuine value and the value at which they're swapped for treasury bills should reflect at least partially the price they would fetch in the open market. The loans that the government will guarantee are again likely to be repaid. And if the government tried to save money but failed to prevent the crisis from spreading further, the ultimate costs would in any case likely be far higher.

The fact that money will be directly injected into the banks, rather than used to purchase poisonous assets, is critical. If a bank's lending is leveraged 10:1 (so for every £10 in loans it has to hold £1 in assets) then every £1 that is injected enables the bank to support £10 of lending. The UK government therefore gets far more mileage out of its investment in terms of its ability to re-stimulate the lending that the economy so desperately requires.

If imitation is the sincerest form of flattery, then Mr. Brown can feel pleased. Over the weekend the European governments indicated that they would adopt a similar approach. Even more gratifying, Henry Paulson (the US Treasury Secretary) suggested that the US would modify its original intention along similar lines.

Part 4: Why it's not Over Yet

Payment is Due

But even if the partial nationalisation of various countries' banking systems prevents a complete credit freeze and avoids global depression, the economic outlook over the next few years does not inspire confidence.

It's time to pay the bill for the credit-fuelled consumption party that has lasted for a decade or more. This means that consumers and financial institutions need to dramatically reduce their debt levels. But so much debt is out there, and the financial institutions are so highly leveraged, that this process of reducing debt will put downwards pressure on asset prices for some time to come. House prices *need* to fall back to historic levels and consumers *need* to save more.

Global readjustment to the new conditions will be painful and will take time. But it is necessary. On several occasions in the last decade central banks have allowed bubbles to inflate as a result of overly loose monetary policy. Then, when those bubbles burst, they attempted to protect their economies from the fallout by lowering interest rates even further.



But in doing so, they allowed new and bigger bubbles to inflate. By keeping money too cheap, they encouraged consumers and firms to take on far too much debt.

Each time they managed to avoid the pain that was necessary, they merely inflated another, even bigger bubble, which meant that the ultimate reckoning will be far more painful than it needed to be.

More Bad News to Come

Commercial banks in particular will remain vulnerable and we're likely to see further bankruptcies soon. The scale of the lending binge still has the potential to wreak vast havoc. There are indications that, given the scale of the rise and fall of the housing market, a good number of Alt-A and even some prime loans are likely to become delinquent. In addition, car loans, credit card debts and home equity loans are all vulnerable and are now often completely unsecured given the increasing levels of negative equity. If you're going to mail the house keys back to the bank, why not throw the car keys in there as well? And these loans have also been aggregated, sliced and diced, and sold far and wide...

This is not just a US problem. Fallout from the property market collapse in the UK is only just starting to work its way through the system. Property prices rose further and faster than in the US and UK consumers are more indebted. The UK also had a boom in more dubious mortgage products such as self-certification loans.

Banks are additionally threatened by some US \$6 trillion in approved credit facilities that they agreed with companies before the credit crunch. Many of these companies are drawing upon this credit already, whether they need it or not, in case the banks are not around to provide it in future. But once again, this then worsens the positions of the banks, thereby making their failure more likely.

And no one really knows how the vast network of CDSs will sort itself out in the wake of the bankruptcy of Lehman and the nationalisation of AIG. And what might another major bankruptcy bring? Even now, Morgan Stanley appears vulnerable. If sentiment were to lurch sharply downwards once again, even Goldman Sachs could be imperilled.

Extreme volatility is likely to be a concern for quite some time to come. Companies that have a requirement for short-term refinancing could well find money difficult to obtain. More companies will fail and more selloffs will occur before the credit crunch is well and truly behind us.



Part 5: Silver Linings

One year ago equity prices were high and value was hard to find. Although house prices had started to fall, the scale of the problems faced by the world economy was huge and some of the nightmare scenarios were truly horrendous.

Now, very substantial problems remain, but we are much further advanced in terms of the retrenchment that was necessary. House prices have continued to fall and equity prices have been decimated in the last few weeks. That does not mean that equity markets as a whole might not resume their downwards plunge. Far from it. But there is now at least some light at the end of the tunnel. The new plans to fight the crisis at last seem to have a good chance of tackling the underlying causes and arresting the vicious circle that threatened to tear the global economy apart.

Whilst substantial problems still remain and bad news will still roll in, it is here that the opportunities present themselves. The sheer scale of the fear that has taken control of the markets over the last few weeks has indiscriminately marked down almost all companies.

We invest solely on the basis of classical value principles. We emphasise companies strong in tangible assets that operate with low levels of debt. We have been holding more than 90% of our assets in cash but we are now seeing opportunities to carefully and gradually move back into the market, one stock at a time. We believe that some of the opportunities to invest in superb companies that are now presenting themselves will, in the future, be seen with hindsight as once-in-a-lifetime investment opportunities.

The key is to invest in companies for which there is no existential risk – that are not in danger of capitulation should credit continue to be hard to come by. Companies for which their products and services will be in demand even if the global economy does take an additional downwards lurch. That can capitalise on solid global trends that are not likely to go away (such as Asian infrastructure development and an oil price that is likely to remain high given the development of economies such as China and India).

When times are good, or only marginally bad, everyone believes that they can be a contrarian investor. Everyone can trot out “The time to invest is when the blood is on the streets”. Well, now is one of those times. If you expected the investment opportunities of a lifetime to come when the worst was clearly over, then you were sadly mistaken.

The chaos will persist, but will reward those with exacting standards who pursue a policy of gradually investing into the most solid companies that have been marked down as a result of non-selective panic. We expect markets to continue to lurch up and down. And we may still have seen nowhere near the bottom yet. But we’re not looking to buy an index and we’re not looking to invest for a few months. There is light at the end of the tunnel and we’re looking to capitalize on irrational panic so that we can achieve superb results over the longer term.



For those that share these sentiments, the next 6-12 months will present some incredible opportunities. But fundamental analysis is vital, as many seemingly attractive investments could well have hidden exposure to liabilities that could destroy whatever value they might possess.

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