Islamorada Investment Management

WHAT WALL STREET STILL HAS NOT TOLD YOU

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INTRODUCTION

How did we get here? What caused this current economic crisis, one of the greatest financial panics in history?

Many on Wall Street would have you believe it was the unfortunate, sudden result of loose mortgage lending standards.

But that is not correct. It is a systemic failure of massive proportions. Most people don't know what caused it, but they accurately sense that something is not right with the system.

We are seeing a perfect storm of greed, aspiration and undeserved trust in things it turns out the experts didn't really understand. This is a self-induced crisis, but it is not easy to point blame at a single group. Many people, both on and off Wall Street, played a role.

Unfortunately, the discussion of the fundamental nature of the system's core problems in most major financial media outlets is often too full of jargon to be truly useful. This does a serious disservice to the individual investor.

To not truly acknowledge the root cause - the explosive growth of formerly obscure financial instruments called credit derivatives - means those same investors may not see the next crisis coming. And the threat of another exotic class of derivatives in particular still looms large.

While the recent pace of institutional failures, mergers and rescues has been dizzying, a few investors saw today's problems developing years ago. Warren Buffett, arguably the greatest investor in the world, issued a warning about the catastrophic problems that certain derivatives could create in 2003. A chronology of events beginning in 2001 also underscores that the crisis was long in coming.

While many investors are focused on whether or not the stock market is near a bottom, the potential for credit default swaps to further roil the financial markets increases each day. It is estimated that the current value of the global credit default swap market is greater than the GDP of all the countries in the world combined. Traders enter into multimillion dollar swap contracts using nothing more than instant messaging programs. Yet most investors have still never heard of these derivatives.

Ironically, many investors continue to look to advisers at Wall Street institutions for advice on what to do in the face of the crisis that those same companies helped create. The following article aims to provide some thoughts from an independent source. We trust you'll find it useful.

What Wall Street Still Has Not Told You

How we really got here, why it was not a surprise and three things you should do right now to protect your financial future

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For many people, waking up to learn about the latest bank implosion or Wall Street rescue plan can be, as one writer put it, like turning on the television to see the fire department burning to the ground. The shock only grows deeper when the fire chief comes out to say, "Yep, this is a bad fire. It could be out of control. And I don't have a clue how many more houses are going to burn down."

If your response to that is, "Seriously, Chief? Aren't you supposed to be keeping an eye on that sort of thing?", then this article may be for you.

I am the managing partner of Islamorada Investment Management. As a portfolio manager, not a financial adviser, I spend most of my time analyzing stocks to buy or sell in our clients' portfolios. That said, I have strong opinions about financial advice as is commonly given on Wall Street. Many advisers are the all-you-can-eat salad bars of the financial industry; they attempt to give you the illusion of choice while steering you towards specific items.

What follows is my attempt to explain the 2008 credit crisis in terms that individual investors can understand. In brief:

The problem is credit. The cause is derivatives. And the appropriate response is not to be worried, but to be angry.

An Early Alarm

He tried to warn us.

In 2003, Warren Buffett wrote in his annual letter to shareholders, "Derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."

Buffett should know. In addition to holding the title of world's richest man, with a net worth of over $60 billion, Buffett had a first hand glimpse of the rat's nest that derivatives could be after he bought a reinsurance company named Gen Re in 1998. Because not even Buffett could determine how risky that book of derivatives really was, he ordered that division sold and immediately began the process of winding down all the derivatives-related contracts he inherited in the acquisition.

Ten years later, the unwinding still goes on. It has cost Buffett's holding company half a billion dollars and an inordinate amount of man-hours to simply exit the tar pit that is the derivatives business. In Buffett's words, "The reinsurance and derivatives businesses are similar: Like Hell, both are easy to enter and almost impossible to exit."

Through shrewd investments and canny acquisitions, Buffett has grown the book value of his company Berkshire Hathaway by 21% a year for 43 years, for a total return of over 400,000%. Now 78 years old, he remains a staunch practitioner of value investing, the central tenet of which is buying shares of companies that objective analysis finds to be significantly underpriced in the stock market. Despite his immense wealth and in stark contrast to most on Wall Street, he is known for his frugal lifestyle. His annual salary of $100,000 is remarkable in this era of overcompensated CEOs, and he still lives in the same house in Omaha that he purchased in 1958 for $32,000. The annual meeting of shareholders for his company drew an estimated 31,000 attendees in 2008. He is, in our opinion, the greatest investor who ever lived.

While few can hope to ever come close to his long-term record, Buffett's ability to keep his emotions in check while investing is worthy of particular note these days. Despite the credit crisis appearing ready to morph into a Clive Barker novel, it is of the utmost importance for individual investors to keep a cool head, too.

The greatest investor in the world warned us all five years before the crisis that eventually surfaced in 2008. While that may be a surprise to you, it should not have been to your adviser.

Let's delve deeper to better understand the credit crunch.

How We Got Here

For a long time, it was easy to get credit.

Businesses and consumers had easy access to credit due to the interest rate cuts the Federal Reserve started making in 2001. In response to a massive stock and capital spending bubble that had recently popped and the events of that September, rates were cut to 1% and stayed there until 2004, after which they were very slowly raised.

Those low interest rates, despite masking large risks, created another bubble, this time in real estate. As money lost in the stock market began to be recouped from rising home prices, consumers kept spending and more people bought homes. As Americans continued to spend, the U.S. fell further into debt with the rest of the world. Foreigners used their I.O.U.s from the U.S. consumer to start their own bubbles back home.

In 2006, those that could least afford to purchase homes but nonetheless did due to loose lending standards slowly started to default on their mortgage payments. In the winter of 2007, the international bank HSBC issued what should have been a major warning – the write-down of tens of billions in loan losses from its 2002 acquisition of major U.S. subprime lender Household International. Policy makers at the time believed the problem to be contained to just the subprime homeowner.

In June of 2007, two Bear Stearns hedge funds with exposure to the U.S. housing market imploded. Still, the problem was believed to be contained.

In August of 2007, the huge French bank BNP Paribas froze withdrawals from three of its funds. For the first time, Wall Street and its institutions began to show concern. Paribas had zero exposure to the U.S. mortgage sector, and if it had difficulties, then it was conceivable that any bank could. Large international banks operating in the global market for interbank loans began to mutually distrust each other. This was beginning of the credit crisis.

In September of 2007, rumors began circulating about various institutions that relied on the now volatile interbank market to run their daily operations. Aggressive British mortgage lender Northern Rock, faced with a panicked public that lined up to pull out banking deposits, was taken over by the Bank of England, the central bank of the U.K.

U.S. housing prices continued to decline. This triggered massive losses in mortgage related derivatives held by large global banks. On October 5, 2007, Merill Lynch reported a $5.5 billion loss. Less than three weeks later, on October 24, Merill updated its losses to more than $8 billion. Losses at most other global financial institutions ensued, but the crisis went back into the shadows for most of that winter.

The failure of several large hedge funds in early 2008 brought the credit crises back into the news, sparking a panic that soon led to the stunning collapse of Bear Stearns, the fifth largest investment bank in the U.S. The Fed organized a takeover by JPMorgan Chase.

Another period of false security ensued. Losses among financial institutions continued and most banks continued to raise money to stem those loses.

On June 9, 2008, Lehman Brothers announced a $3 billion loss, once again thrusting the credit crisis onto the front pages. This time, however, the fear did not recede.

IndyMac, a bank started by the aggressive mortgage lender Countrywide and similar to Northern Rock in the U.K., was taken over by the FDIC.

Next, the government sponsored enterprises (GSEs) Freddie Mac and Fannie Mae, which bought mortgages from lenders, were effectively taken over by the U.S. government. This led to serious doubts about the credibility and share price of all financial companies in the U.S. Lehman Brothers filed for bankruptcy. Merrill Lynch ran into the arms of Bank of America. AIG, the largest insurance company in the world, also succumbed to the pressure and was bailed out by the Federal Reserve.

Having had enough, Treasury Secretary Hank Paulson then put forward a $700 billion plan to remove troubled assets from the balance sheets of U.S. institutions. Two weeks passed between his introduction of his plan and its passage by Congress. The credit markets continued to be frozen. Finally, on October 14, 2008, the government of the United States of America announced the partial nationalization of its major banking institutions. Wall Street as it had been known had spectacularly and utterly failed.

To completely explain how we got here, we look to the common denominator found at each of these global financial institutions.

The Root Cause

One of the amazing things about Wall Street is what I like to call the Revenue Generation to Common Sense ratio. It has been off the charts the past few years, and is now coming back to bite all of us - and hard. While that topic itself is worthy of a separate article, for now I'll remind investors of an important, undeniable truth that is often lost in the daily noise of the markets:

> Wall Street exists to sell financial products and services. Whether or not investors make money from using them is of secondary concern.

Here's a simple question that Abe Lincoln used to ask that better underscores the root cause of the mess we're now in:

> Q. How many legs does a dog have if you call the tail a leg?
>
> A. Four. Calling a tail a leg doesn't make it a leg.

Packaging thousands of potentially bad mortgages together and pronouncing the new bundle "safe" does not, in fact, make them safe. In spite of what the investment banks, rating agencies, government sponsored enterprises and institutional investors led each other to believe, the tail is not a leg.

The implicit equation that many banks used to sell one of their most highly profitable products on a massive scale is this:

junk + junk + junk + junk + junk + junk + junk = gold

The amazing thing is that this financial alchemy worked. Big institutions bought into this for a long time. But ask anyone who sat through high school biology what happens when you introduce something toxic into an otherwise healthy system. It certainly doesn't magically transform into something good. Instead, it makes the whole system bad. Engineers call it garbage in, garbage out. But on Wall Street, the laws of basic high school biology had been ignored for a long time.

So how could something so fundamentally flawed be believed so fervently by such sophisticated institutions managing huge amounts of money?

One word: derivatives.

The True Culprit

In addition to enabling companies to report earnings that are often wildly overstated, derivatives also create a daisy-chain type of risk that is only now becoming obvious. While they come in an exotic range of acronyms, the effect of a certain class of derivatives has been to separate the issuing and pricing of a mortgage from the evaluation of its underlying risk.

Derivatives essentially marginalized the traditional role the local banker had in loan approval and seeded the crisis that surfaced in 2008. Mortgages used to be issued by lending officers who knew both borrower and property. Derivatives enabled them to be mass-produced like widgets on an assembly line.

Don't be intimidated by the jargon used to describe the problem. Instead, picture the entire multi-trillion dollar mortgage market as a three-story building in a flood zone.

The most conservative investors own the top floor of the building, and earn reasonable rent from their tenants. More aggressive investors own the middle floor and can charge more rent because their tenants are slightly less dependable when it comes to writing checks every month. The most aggressive investors own the ground floor and charge the highest rent of all because their tenants sometimes do not pay rent.

Whenever a storm comes in, the ground floor (representing the most risky mortgages) will flood. The investors that own those floors get nothing. But they're not stupid. They know a flood zone is probably going to be a poor place to invest. So who on earth who would buy a high risk mortgage?

For a long time, nobody would. But then Wall Street created an answer. By effectively combining all of the ground floors in of all the buildings in the flood zone through the use of derivatives, banks and GSEs were able to slice and package even the riskiest investments into bundled products that sounded much less risky than they really were. Because the agencies in charge of *rating* those investments were also paid by the same institutions that *created* them, even formerly conservative investors started to buy some ground floor properties.

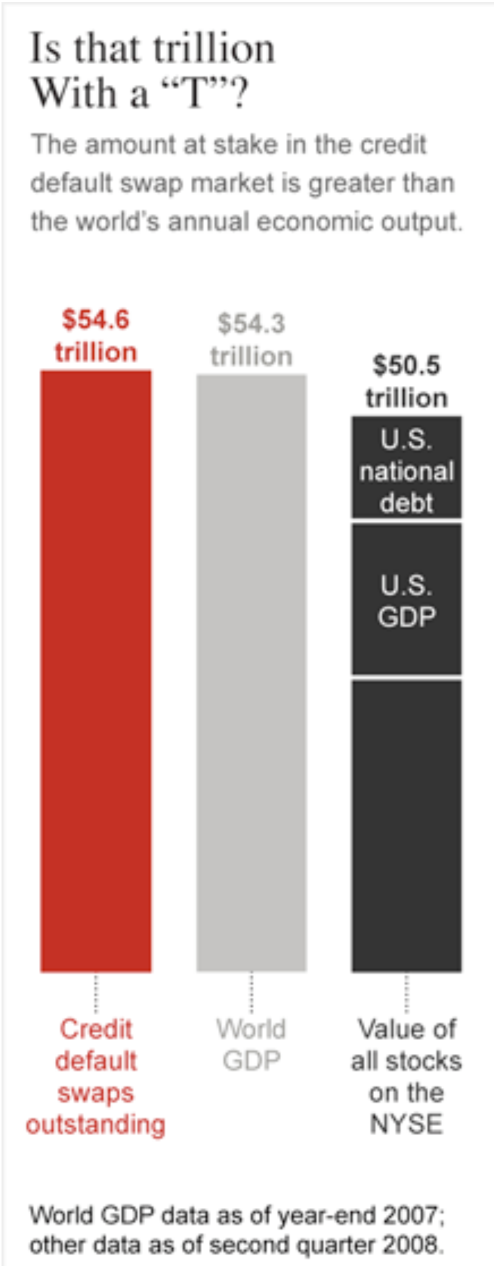
After all, the logic went, if you own one building and it floods, you have a big problem. If you own a hundred properties and one floods, you'll barely notice. Investors were soon able to completely ignore the key question, Should we really be renting our building to people who might not pay us?

All went well until those risky mortgage investments started to show increasing defaults. The ground floors started to flood. Prior to then, ground floor investors believed the bankers who sold them the investments and the agencies which rated them. As a result, the investors didn't charge their tenants high enough rent to compensate for the risk they really represented. Because of derivatives, the risk wasn't perceived to be that bad.

Once those ground floor investors began to glimpse the scope of problems they might be facing, however, they abandoned those ground floors in droves, seeking the safety of the upper floor investments. However, no one owning a penthouse suite would let former ground floor investors in because they now had plenty of bad credit of their own.

That, in a nutshell, is why we're now stuck. The credit markets have seized up because the top floor owners don't trust the high risk investors now banging on their doors. Those investors can't clean up their books. And the floodwaters continue to rise.

The Other Shoe Yet to Drop



SOURCES: ISDA; WORLD BANK; NYSE; BUREAU OF ECONOMIC ANALYSIS; DEPT. OF TREASURY

The current meltdown in the credit markets has caused panic in the stock market. While it is true that the current stock market turmoil is revealing great companies trading at cheap prices, we fear there is another shoe to drop. In short, while currently seeing the effects of the failure of one class of derivatives – RMBS, CDOs and CMOs, specifically – we have yet to see the fall-out from an even bigger class of derivatives known as credit default swaps, or CDSs.

A CDS allows an institution to unload its risk exposure to a third party. While designed to insure against defaults on debt, swaps are not considered insurance in the traditional sense by regulators. Buyers of credit default swaps make monthly payments to sellers, who agree to make a large payout if the underlying instrument goes into default.

AIG appears to have sold credit default swaps to nearly every major financial institution on earth. One analyst estimated that had AIG collapsed, it would have cost its CDS counterparties $180 billion.

Despite being the key reason behind the demise of AIG, credit default swaps are still relatively unknown outside the world of hedge funds. They need to be better understood. As shown at left in a recent article in *Fortune*, one of the only articles in the popular press to address CDSs, the current value of the credit default swap market is *greater than the GDP of all the countries in the world combined*.

While some of those figures likely double count certain swaps, the sheer size of the market is quite unsettling. As if that wasn't enough, here are a couple of other points about credit default swaps that underscore our concern:

1 – CDSs are contracts, rather than securities or insurance, which makes them much easier to create and sell. As reported in *Fortune*, these multimillion dollar contracts are often executed in minutes between traders using nothing more than instant messaging.

2 – These swaps require little to no cash upfront to enter into the contract.

3 – A CDS can cover any underlying asset or debt security.

4 – There is no regulatory agency in charge of credit default swaps, no centralized clearinghouse that administers them nor anything publicly disclosed about them.

As you might guess, investment banks, insurance companies and hedge funds loved credit default swaps, as their meteoric growth indicates.

SOURCE: ISDA

These swaps, while originally intended to serve as insurance on debt defaults, are now in our opinion a step below gambling. In the same article referenced above, *Fortune* attempted to explain credit default swaps to the unfamiliar reader. The analogy went like this:

> Bill thinks his neighbor Larry is a bad driver. Bill goes to an insurance company and gets collision insurance on Larry's car because he thinks Larry will crash it. If he does, Bill will collect on the insurance he purchased.

Note that Bill does not own Larry's car. He has zero ownership interest in any part of it. By buying insurance on it, however, he can nonetheless profit from Larry's mishap.

The *Fortune* analogy missed what we believed are two other hugely important points about credit default swaps.

1 - Even though Larry's car is only worth $10,000, Bill can take out an insurance policy on the car for $10 million; and

2 – Larry has no say over whether or not any of his neighbors take out insurance policies on his car, nor will he be notified if they do.

Both of these aspects of CDSs are huge problems. Why? Because, to continue the analogy above, it rewards Bill for cutting Larry's brake lines. By causing the car to crash, Bill will collect a lot of money.

Unlike real insurance, the amount of capital supposedly insured by credit default swaps bears no relation to the actual value of the underlying instrument it is meant to protect. The system encourages speculation on a multi-trillion dollar scale.

Credit default swaps represent another huge risk to the global financial system, and no one is talking about them. But if you're thinking about investing in the months and years ahead, you owe it to yourself to learn more about these swaps and the risks they pose to the markets and your portfolio.

What To Do Right Now

Despite the efforts of Wall Street to place investors in various boxes according to style, risk tolerance, and preferred market cap, the reality is that every person's financial situation is extremely unique. Here are three things all investors should do as they wrestle with the question of what to do in light of the recent market chaos.

First, acknowledge that most of the damage to your portfolio has likely already been done. To sell everything now could mean you compound your errors exponentially by exiting the market at the worst possible time.

Next, you need to ask yourself two important questions:

> **1 – Am I any smarter about what I am invested in now than I was before this crisis began?**

If not, and you're using an adviser, it's time to find a new one. If you're a self-directed investor who has been struggling, it may be time for an honest conversation with yourself. Diversification is not an excuse to be uneducated, and sending your money to someone else to manage does not relieve you of the obligation to know where it ends up. Your financial future is too important.

Pledge to educate yourself more about what you're invested in, and why, or find a portfolio manager or adviser who will explain it to you. You can also find a fee-only adviser on NAPFA.org to be assured your financial advice is unbiased and free from the conflicts that plague Wall Street.

> **2 – What is the real cost of the investment advice I have been getting?**

Now is the time to think hard about where you get your investment advice and what it has really cost. Do you know exactly how your adviser gets paid? If he works on commission, he is effectively being paid to sell you a product, and, unfortunately, whether or not that fund or annuity or stock is truly in your long-term interest may be of secondary concern to him. Do you know how much you paid your adviser last year? Is your adviser truly accountable for the performance of your portfolio? Are his incentives truly aligned with your own?

In answering those questions, don't confuse the investment business with investing. The two could not be further apart. As evidence, I point to one of the largest ironies of this current crisis - that it was in large part caused by the "best and brightest" on Wall Street.

It turns out that the same institutions that have been advising people for years how to invest their money have been managing their own money in a much different way. While Merrill Lynch, Lehman Brothers and Bear Stearns have for years been publicly preaching the ideas of diversification, avoiding the use of margin and promoting conservative asset classes when investing, its clear now that they never really believed in their own advice all along.

The Outlook for Stocks

I am as excited as ever about the returns that investors in the stock market should realize over the next three to five years.

If you're not going to invest for the long-term, however, my advice to you is two-fold:

> 1 – Consider yourself a speculator, not an investor. If you can't stomach the idea of your portfolio going down another 50% the next six months, only to see it increase exponentially three years out, then you shouldn't be investing in the stock market at all.
>
> 2 – If you're going to invest, you need a comprehensive, well thought-out strategy. As a wise man once said, choosing individual stocks without any idea of what you're looking for is like running through a dynamite factory with a burning match. You may live, but you're still an idiot.

While no one knows if the bottom has been reached in the stock market, the risk-reward profile is now unequivocally on the side of the long-term investor. Stick to stocks, ignore the noise, think long-term and buy great businesses when the market presents them to you cheaply. This is one of those times, as Warren Buffett's recent investments in Constellation Energy, Goldman Sachs and GE would indicate.

There are some unbelievable blue chip bargains right now in the stock market for anyone willing to look beyond the next six months. American Express, in my opinion one of the top 10 businesses to ever grace this good earth, is one of the more obvious. As I write this investors can also buy shares of Budweiser for $59 a share – despite the fact they will be worth $70 each when they are eventually acquired by InBev in three or four months. If you can find those anomalies in the market – and right now there are plenty – your annualized return could be more than 35% a year - without any help from Wall Street.

Plenty of risks remain in this market. In spite of all the recent headlines, however, the country is not at risk of collapse. We will ultimately emerge stronger from this crisis. While nobody knows when it will happen, I can tell you that soon will be the time to create significant wealth in the stock market. And you don't need Wall Street to do it.

Cale Smith is the Managing Partner of Islamorada Investment Management, an independent Registered Investment Adviser managing the portfolios of high net worth individuals and families in the value investing tradition of Warren Buffet. To contact him, e-mail csmith@islainvest.com. To receive our newsletter, "Spinach in a World of Chocolate," please send an email to spinach@islainvest.com.