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What a historic quarter! Even more, what a historic September! Just two days before the end of this quarter, we witnessed Black Monday Part II where the S&P 500 nearly declined 9% in one day. And that's not all that happened.

In September alone, the face of Wall Street underwent some major surgery. Our last letter discussed the possibility of a government bailout of Fannie and Freddie. Not only did the unofficial become official with these two government sponsored entities, but Merrill Lynch, the third largest investment bank is pending a sale to Bank of America. The fourth largest investment bank, Lehman Brothers, filed for bankruptcy. (Consequently, the fall of Lehman caused the Reserve Primary Fund and a Putnam money market fund to "break the buck" – this is extremely rare, something that hasn't happened since 1994). Goldman Sachs and Morgan Stanley applied for and attained bank status. The culmination of these events has resulted in the extinction of large, independent *investment* banks on Wall Street (recall that Bear Sterns was absorbed by JPMorgan in March).

Also in September, the insurance giant, American International Group (AIG), was rescued by the government. Washington Mutual became the largest bank failure in U.S. history with more than \$300 billion in assets. Compare this to the failure of Continental Illinois National Bank in 1984 which had \$40 billion in assets when it closed. At a \$1.9 billion price tag, JPMorgan purchased WaMu's 5,410 branches in 23 U.S. states from coast to coast. Additionally, Wachovia was acquired by Citigroup (or will it be Wells Fargo?).

And there you have it – years worth of news crammed into one month.

### **Financials**

Amidst all of this turmoil, the financial sector has taken a beating. Fortunately, your portfolio has had very low exposure to financials, especially relative to the S&P 500 index. One might think that we'd be sifting through the financial bargain bin now that this sector has plunged, but in this instance, this is not the case. We continue to have an aversion toward most financials.

Many value investors generally find financials attractive because of their low P/E multiples, which make them appear cheap. However, when you strip out the leverage, they actually trade in line with other stocks.

We also do not like the risk associated with banking assets themselves. No bank can pay back all of their deposits on demand, and thus none of them are immune from a "run on the bank." During a panic, nobody sticks around because they think "this bank has crisper dollars" – money is simply a commodity.

Finally, banks are generally leveraged anywhere from 10, 15, and even 20 to 1. This means that for every dollar of assets lost that is not offset by fresh capital, the bank needs to shrink its assets by \$10-20 to maintain adequate capital. Since banking assets can be written with the stroke of a pen, the problem is ascertaining which companies have fake versus accurate book values. Not even the management of these major financial institutions truly know what is on their balance sheets. As an analyst, a minor error in estimating true book value could mean the difference between a fabulous investment and bankruptcy.

Therefore, despite the seemingly attractive price to book values of many financials, we remain hesitant to invest in this sector due to the lack of transparency, resulting in an inability to properly value the banking assets. We want you to take comfort in knowing that we will continue to be extremely cautious before committing any capital in this sector. Instead, we continue to have your portfolio primarily positioned in global businesses with little debt that create non-durable, recession-resistant products such as Coca-Cola, Procter & Gamble, and Johnson & Johnson.

### **American International Group (AIG)**

AIG, the world's largest insurance company, is a blue-chip stock that has long been a component of the Dow Jones Industrials Average, until the most recent turn of events. The main source of its problems, however, did not stem from its traditional insurance subsidiaries, but from its derivatives unit where it sold credit default swaps on CDO's (collateralized debt obligations).

Essentially, these swaps represent insurance that AIG sold to protect investors against default. As housing prices have fallen and defaults have been on the rise, CDO's began selling at extremely distressed levels, making it appear as though AIG would pay out enormous amounts of insurance. To comply with accounting standards, AIG was forced to report large write-downs – whether they were warranted permanent losses or not. This is called marked-to-market accounting. This means that even if some of the CDO's never defaulted, in the interim, accounting rules required AIG to run “paper” losses through the income statement. Then, for the portion of CDO's that never actually defaulted, those losses would reverse back into earnings. For the prior three quarters ending on June 30<sup>th</sup>, AIG marked down the value of their credit default swaps by about \$25 billion. They also had to write down another \$15 billion on other investments, such as their own investments in mortgage-backed securities.

The challenge AIG faced is they are contractually obligated to raise capital for their policyholders to maintain credit ratings. Initially, rating agencies felt AIG had sufficient liquidity and capital to meet their collateral requirements, despite the enormous write-downs. However, Lehman Brothers, also a big player in credit default swaps, was allowed to go bankrupt on September 15<sup>th</sup>. Thus, investors associated AIG with Lehman Brothers, which created a massive panic and started a chain reaction. Shareholders feared their fellow shareholders would sell and drive down the price of the shares to a point where AIG would be unable to raise capital. As each investor bails, eventually a self fulfilling prophecy occurs. Investors created their own self-destruction – somewhat similar to a run on the bank or to the prisoner's dilemma used to explain a cartel.

After the share price nosedived, it became apparent the company's access to capital in the short term was extremely limited and they were consequently downgraded. This downgrade meant that AIG needed to post collateral to its counterparties quickly. They couldn't sell stock at rock bottom prices. To avoid bankruptcy, their only option was to find a short term loan to appease the rating agencies which they would in turn eventually pay off with the sale of internal business units. Nobody was willing to extend the lifeline, and AIG simply could not sell off their profitable, but illiquid, business units fast enough.

Because of the far reaching effects worldwide (AIG has operations in more than 130 countries), the government felt that it would be more risky to do nothing than to extend the loan AIG needed to survive. The Federal Reserve stepped in and made a "Godfather" offer AIG couldn't refuse. They offered to lend up to as much as \$85 billion over two years with some steep terms. AIG would pay a 2% commitment fee up front (\$1.7 billion) and make interest payments of LIBOR + 8.5% on the amount they borrow, and additionally pay 8.5% interest on the portion it doesn't even borrow! The government would also take an overwhelming 80% stake in the company. With nowhere else to turn, AIG was forced to accept the government loan, permanently reducing the franchise value.

We previously recognized that the problems of a housing crisis and a slowing economy were real, but given our analysis, we felt that the market was overreacting and there seemed to be an ample margin of safety warranting an investment. We felt it was wrong to put AIG in the same boat with failed banks, such as Bear Sterns or Lehman Brothers. For one, AIG did not appear as vulnerable as other financial companies because there is a core insurance business backing the company, and customers of an insurance company cannot withdraw their deposits like depositors can at a bank. You simply cannot make a run on an insurance company in the same way you can on a bank. In this case, we underestimated both the degree of panic that would ensue from the shareholders themselves, and the effects this panic would have on the business itself.

Additionally, AIG appeared well capitalized and was generating approximately \$20 billion of pretax, normalized earnings. If CDO's should reach fire-sale prices and force more substantial write-downs, we took heart knowing AIG had proven they had the ability to raise capital earlier this year. Initially, misjudging the severity of the housing bubble, CEO at the time, Martin Sullivan, incorrectly thought that AIG had \$15-20 billion of excess capital. When they realized there was no excess and they actually needed more money, not only were they able to raise capital, but they raised a significant amount – an additional \$20 billion cushion.

Should they still need even more capital, and if raising debt or equity were to become too expensive, we knew AIG had other options such as shedding any one of their numerous valuable franchises. They would most likely retain their domestic property & casualty operations, while disposing of other major segments such as their domestic auto insurance business unit, their VALIC and SunAmerica U.S. variable annuity units, and their majority stake in Transatlantic. Other possibilities included selling 21st Century or their consumer finance unit, American General Finance. Another probable candidate for sale would be the aircraft leasing unit named International Lease Finance Corp. (ILFC). Founded in 1973, ILFC is the

largest single customer of both Boeing and Airbus, leasing over 900 airplanes with asset values of nearly \$50 billion to major airlines. So far, this business has been unaffected by the market downturn, posting record results during the second quarter with net income of over \$200 million. Yet another possibility (but less likely candidate because of the difficulty of selling it) would be AIG's foreign life insurance business which generated over \$6 billion last year. It seemed reasonable to believe that, if needed, with all these other high quality assets, somebody would be willing to loan cash until these illiquid assets could be sold off. And even under fire-sale conditions, we felt they could sell any combination of these businesses for \$40 billion.

In the end, *the fall of AIG was a liquidity problem, not a value problem*. Today, the value of these business units remains. However, the liquidity problem allowed the government to assume 80% of that value. AIG will now scramble to sell off these franchises to pay down the government loan, and the prices they fetch under extreme duress and the speed at which they sell them will ultimately determine the share price. As for the government, they appear to have made a wise investment, and they likely stand to make a handsome return at the shareholders' expense.

Never before have we had such a massive government intervention in the American economy. The AIG rescue was a major historic move because it will likely put the government in a controlling position of a public company that is not tied to the government (unlike Freddie and Fannie).

### **Credit & the Bailout**

With the current news about credit problems and the bail-out plan, it may be difficult to ascertain what is really going on.

In our last letter, we mentioned that a gigantic credit crunch is believed to be the main cause of the Great Depression. Allow us to briefly explain why credit is indeed so critical. It extends far beyond an individual consumer being denied a credit card, a student loan, an auto loan, or a home mortgage. It extends far beyond a single entrepreneur being unable to secure a loan to purchase machinery and inventory and begin a new business. Imagine for a moment that you are a custom homebuilder. Without access to credit, you cannot hire a cement worker, a framer, a plumber, an electrician, a roofer, a painter, a cabinet installer, a flooring installer, a landscaper, the list goes on. In this case, all of these aforementioned businesses suffer from one person being unable to secure a loan. This, of course, would lead to job losses, which slows down consumer spending. Thus, the problem cascades into even more businesses. Retailing, manufacturing, materials, shipping, and many other businesses all suffer, continuing the cycle. Thus we see that all industries across the economy are intertwined, with credit being the lifeblood. Simply stated, just as a car engine locks up with no oil, an economy locks up with no credit.

A major dilemma of the continued credit deterioration has now become the element of panic. Marked-to-market losses are mounting, investors are dumping shares, and deposits are being withdrawn by ordinary Americans. All three of these forms of panic are causing capital ratios to suffer and lending capacity to shrink. Banks are finding it difficult to support present debt levels, let alone feed the

economy with new credit. Thus, the key to restore credit to the economy is to *calm the panic*, otherwise banks that do not deserve to go under will continue to fail.

Take, for example, Wachovia Corp. Wachovia had a strong retail franchise brand with a large branch network. Their capital ratios were well in line with regulatory requirements and they held a solid base of more than \$400 billion in *growing* deposits. There was evidence that their lending standards were much tighter when compared to others, such as Washington Mutual. Still, extreme fear led to assets on their balance sheet being marked-to-market at distressed prices, forcing them to raise capital, which diluted shareholders, leading to an investor panic, and the domino effect began. The final straw was the seizure of Washington Mutual on Friday, Sept. 26<sup>th</sup>. Wachovia became victim of a panic-led run on the bank almost overnight. Thus, whether a bank deserves it or not, unsubstantiated fear can create an implosion. Many of the banks that have already failed had managements affirming they could weather the storm. Not even management can predict the degree of a panic, nor can they seem to mitigate it.

If not calmed, financial contagion can spread all over the country and in a worst case scenario we would essentially see a run on the entire financial industry leading to a “Greater” Depression. While seriously unlikely, a complete banking collapse would theoretically bring us back to the days of bartering. Understanding the need to calm fear, Treasury Secretary Paulson announced a U.S. government sponsored \$700 billion bailout plan.

There are a few misconceptions about this plan that should be noted:

1. This is not a bailout of the rich, but rather a bailout of banks on Wall Street to rescue the ordinary American on Main Street. Hopefully, the custom home building example above helps explain why every American would be affected if this credit mess were allowed to spin out of control.
2. The government is not *spending* taxpayers’ dollars, but rather they are *investing* our dollars in distressed mortgage-backed securities that are plaguing our financial institutions. In fact, if managed correctly, the government could actually *make money* for the taxpayers.
3. The government is not looking to favor one industry over another. They have a responsibility to protect the banking system, because without the financial industry, there is no economy.

The design behind the bail-out plan is for the government to use this \$700 billion to purchase securities that are in this downward spiral. As explained earlier, each time the prices on assets drop in the marketplace, the banks need to write-them off as losses. As losses mount, capital ratios become slimmer and this reduces banks’ ability to extend credit. Currently, in aggregate, these securities are not trading in line with the actual performance of the loans if held to maturity, but rather they are trading at levels set by panicked sellers trying to outrun the falling prices before capital ratios suffer even further. Thus, they are trading at what is referred to as “firesale” prices. If the government were to purchase these distressed securities, financial institutions would no longer feel pressure to unload these troubled

assets from their own balance sheets and thereby prevent capital ratios from suffering. As capital ratios finally stabilize, the ability to extend credit returns.

We wish we could recommend alternatives because we are strong believers in the free market. Clearly, the government was not created to invest our dollars – we loathe the idea! But the fact remains that there appears to be no entity with enough capital to stop the short term panic, with the exception of the U.S. government. Perhaps Jonathan Lang said it best in a Barron’s article dated September 29, 2008, “While we worship unfettered free enterprise, occasionally the Adam Smith invisible hand goes spastic and must be restrained.”

We are not saying this is the best plan or the exact plan that must be instituted. In fact, the details have not even been disclosed, so we are not sure why people are so convinced to be for or against it. What we are saying is that something needs to be done, and we are encouraged to see the government is at least striving to do something to stop an unnecessary downward spiral, instill confidence, and unfreeze our credit markets.

The real concern should be, once the storm settles, how and when will the government restore the financial industry to the free market.

### **Concluding Remarks**

While we have been through many crisis before, the combination of variables we are facing today are unprecedented. The headlines of today will long be remembered.

During all this chaos, it could be easy to get nervous and anxious regarding the financial future. We would encourage you to rid yourselves of all the noise stemming from the media and remain focused on the fact that you are the proud owner of strong, individual businesses. In the short run, stock prices may not reflect the underlying worth of a business, but ultimately, the share price will converge with the intrinsic value. Value is always recognized over time.

We appreciate your confidence, particularly during these challenging times. We continue to work diligently on your behalf, being on the constant look out for attractive investment opportunities.

Sincerely,

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