

## **Insight March 2009 Update**

*“No passion so effectually robs the mind of all its powers of acting and reasoning as fear.”  
-Edmund Burke*

**Will stocks ever provide great returns again?  
The short answer is yes!**

**What caused the sell off in stocks and bonds?**

Fear, a lack of confidence and trust are the primary causes of the emotional collapse of stock and bond prices. Stock prices as measured by the S&P500, dropped by 38% in 2008 and stock prices as of March 9, 2009 were down another 25%. Individual and institutional investors have lost probably over 50% of their retirement assets. Most retirement plans, be it state, municipalities, labor or that of corporations are underfunded. What and who caused so much damage? In regard to what caused the collapse of prices one could write a book...and there are a number of books available now and more to come. It is clear to everyone that our country has experienced a housing bubble, i.e., house prices went up too much over the past several years. This was caused by easy money and greed. The players were numerous: real estate agents supported by over-inflated appraisals and irresponsible behavior of buyers and lenders. Mortgage lenders, investment bankers and Government Sponsored Enterprises (GSE's) such as Freddie Mac and Fannie Mae were involved in packaging sub-prime mortgages and getting them rated AAA and selling them to buyers that had no idea of what they were buying. A lot of the blame has been placed on sub-prime mortgages. Loans were made to people with poor credit ratings, poor ability to pay off the loan, and to speculators flipping properties. The vast majority of defaults to date have been sub-prime. These defaults are causing the prices of homes owned by people with good credit ratings and that are paying their mortgages to fall. The story doesn't stop here. Above sub-prime mortgages in credit quality are Alt A mortgages also known as NINJA loans...no income, no job and no assets. There's more. There are adjustable rate mortgages (ARM's) that were made with teaser rates...and promoted at one time by key officials in government. Then there are the exotic mortgages such as interest only mortgages and so on. All total several trillion dollars are involved.

Political leaders of both parties in Washington, D.C. have played a major role in the destruction of the wealth of individuals and organizations here and abroad. The lack of regulation and enforcement of existing regulations...and looking the other way on things that were wrong are root causes. Were these developments due to incompetence, being misguided or just plain self serving? Specific examples are too numerous to list. Certainly the failure to oversee the GSE's and to regulate lending practices are prime examples. The removal of the uptick rule (a stock must trade up before it can be shorted) on July 6, 2007 gave a major advantage to those that short stocks, particularly those with huge sums of money such as hedge funds. In a weak economy when there are few buyers of stocks, short sellers can ruin companies, industries and damage the economy. The elimination of the uptick rule has cost individuals and institutions billions, if not

trillions of dollars. And some of the individuals involved take home income of as much as \$1 billion a year. Forget the \$10 million or \$20 million bonuses paid out by various other firms.

Then there are unregulated derivatives and financially engineered products such as Collateralized Debt Obligations (CDO's) and Credit Default Swaps (CDS's). A CDO is a pool of mortgages that secure a series of bonds. Many of these bonds were rated AAA but the underlying mortgages are all probably BBB or lower. A CDS is a simple insurance contract in which the seller of the CDS agrees to receive say \$200,000 a year to agree to pay the buyer say \$10,000,000 if the particular company defaults on its \$10,000,000 of debt, typically bonds. Supposedly, AIG sold CDS's covering many billions of dollars. As an example, assume that AIG sold CDS's guaranteeing \$400 billion of debt and that 3% of that amount was from companies that went bankrupt. Then AIG would owe \$12 billion. More than AIG makes in a year. So far out of the \$173.3 billion AIG bailout, AIG's housing-related bets have cost U.S. tax payers about \$52 billion.

It has been estimated that there are about \$65 trillion of CDS's. The total derivative market including interest rate swaps, currency swaps, etc., probably is somewhere around \$400 trillion.

Since the beginning of the year we have seen a major run on bank stocks partly because some banks were exposed to poor performing mortgages, various derivatives, etc. Bank stock prices declined very sharply. There was fear that banks would be nationalized. The elimination of the uptick rule, the Troubled Assets Relief Program (TARP) debate, and the failure of the government early on to publically make statements about supporting the private banking system, and letting rumors of nationalization run rampant has caused unbelievable damage to stocks in general. The financial sector at one time made up about 18% of the stock market. Destruction of 18% of the market and the fear of nationalization triggered a lot of selling. Even in recent weeks government officials have made statements that damaged insurance, healthcare and travel industry stocks. Even one of the best industrial companies in the U.S., General Electric, saw its stock fall 57% from January 2<sup>nd</sup> to March 9<sup>th</sup>.

Without question the poor economy and the lack of government oversight, particularly from Congress, in the past five to six months contributed to the loss of confidence and trust. Add to that the loss of moral and ethical behavior in the private sector as well as in the government and the result is an unprecedented level of FEAR. And fear results in less and less consumption...about 70% of gross domestic product (total output of goods and services) consists of what you and I purchase. Unfortunately, the people that government is trying to help are getting hurt the most.

What the country needs is implementation of constructive programs. And this is beginning to happen. The U.S. is the greatest country on earth and if we work together we can solve not only this financial crisis but many of our other problems...and put this Republic back on a growth path.

**What is ahead?**

For stocks to advance in price we need to see the financial system stabilized and we need to see home prices stop falling. Beyond these items the overall economy needs to be stimulated. We are beginning to see for the first time since last fall that government programs, monetary and fiscal policies have a high probability of resolving critical problems and moving the economy forward.

One of the great causes of fear was and for some still is the possibility of a total collapse of our financial system, primarily because of excessive leverage throughout the system. We will not see a total collapse. Last fall the Troubled Asset Relief Program (TARP) was introduced that allows the U.S. Treasury Department to purchase \$700 billion of "troubled assets". When the second round of TARP early in the year was being discussed a public debate about nationalizing banks arose. We are past that debate and TARP has played and is playing a significant role in helping to stabilize the financial system...with the exception of AIG.

Banks are undergoing a stress test that will determine the health of each bank and how much capital, if any, they will need to continue to operate. Once this step is completed confidence will improve. A turn is taking place now. Several banks made a profit in January and February.

Another major program is the Term Asset-Backed Securities Loan Facility, or TALF, with an \$800 billion implication. The TARP program has been referred to as the financial bailout program. TALF is known as the consumer bailout. The new president of the Federal Reserve Bank of New York, William Dudley, described TALF in a recent speech before the Council on Foreign Relations as a two stage process that begins this month. The first stage aims at consumer debt, auto loans, student loans, credit card loans and some business loans. The second stage may be directed at creating demand for other securities. This would create demand for low-rated as well as high-rated securities and older problem loans that are sitting on bank balance sheets creating losses, as well as new loans.

Another key to getting the financial system back to good health is to stop the fall of home prices. Without home prices stabilizing, bank assets may erode further, credit markets may stay tight and the economy may continue to slow. However, there is hope. The Home Affordability & Stability Plan (HASP) is directed at: (1) boosting home demand by lowering mortgage rates and making conventional loans more accessible; (2) turning the tide of foreclosures. HASP will also help responsible homeowners refinance to prevent defaults on conforming loans. The plan also aims at opening up the secondary market for mortgages by strengthening the capital base of the GSE's.

The other major driver for improving the economy is government deficit spending...and it is very high. It exceeds anything that we have seen in the past 50 years. This year's fiscal budget is likely to exceed \$1.75 trillion for this fiscal year. In the last 12 months over \$900 billion has already been spent...and most of it since last August. For the 2009 fiscal year that starts on October 1<sup>st</sup>, \$3.6 trillion of spending is planned. Even though the total output of the U.S. economy is about \$12 trillion some believe that the U.S. can handle this level of spending. Never-the-less, there is considerable debate about this amount of spending. Insight's position is that the U.S. can handle it, but it must be spent wisely and we must have a plan to remove some of the stimulus to keep inflation in check. We are confident that the Chairman of the Federal

Reserve Bank, Ben Bernanke, is well aware of the potential for inflation and will take constructive action when needed.

The Federal Reserve has also lowered the Federal Funds rate to nearly zero and may actually purchase 30 year U.S. Treasuries. Many loans have interest rates linked to 30 year U.S. Treasury Bond yields. One positive effect is that we have seen mortgage rates drop almost 1% to near 5%.

It is also noteworthy that money supply (M2) has recently been growing at about a 20% annualized rate. This coupled with low interest rates and the aforementioned TALF will eventually have a positive affect on consumer spending.

Given low interest rates, the high level of deficit spending, TARP, TALF, and HASP, we believe that the U.S. economy is on the mend.

### **What about my portfolio?**

Insight's investment process has an established track record that confirms that Insight is one of the best money managers in the country. As a client of Insight you come first in all we do. During this market decline we have increased our cash holdings where we have had discretion to do so. Secondly, when we have come out of major market declines in the past our clients have done very well. Our investment process screens all actively traded stocks every day and on a daily basis we are searching for top performing stocks that have good fundamentals going forward.

The longest recent bear market (2000-2002) lasted 999 days and dropped 38%. This market resembles the 1973-1974 stock market in some ways. It lasted 694 days and went down 45%. This market started to fall October 9, 2007. As of March 9 this year it has fallen more than 50% in 516 days.

We may be bouncing along the trough right now. If history is any kind of guide stock prices start an upward movement about 6 months ahead of the economy improving. The big question is when will the economy turn up? We believe some positive signs will develop by the third quarter and we feel confident, given the tsunami of stimulus, that stocks will be higher in the October 2009 – February 2010 time frame.

In the meantime expect stocks to be volatile with rallies and fall backs until investors are confident that the economy is working. New regulations, other programs yet to be announced and re-instatement of a meaningful short sale uptick rule will be pluses for stocks.

Again, Insight has a very good record coming out of most bear markets. Patience with a capital "P" is required. We believe that stocks in your portfolio are undervalued and that the outlook for your portfolio over the next year is very good.

Best Regards,

A handwritten signature in black ink that reads "Jim Collins". The signature is fluid and cursive, with a long horizontal stroke at the end.

Jim Collins, CFA  
Chairman and CEO

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