# The Equus Report

—BY BARNABY LEVIN

## "LET'S BE CLEAR..."

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## "Let's Be Clear…"[1]

Two years ago in late 2006, we celebrated positive growth in every country in the world for the first time in history[2] and I quickly broadened the scope of our Large Cap portfolio from 15 to 25 industries in order to gain more exposure to more opportunities. In similar fashion, our Emerging Market portfolio encompassed 13 distinct economies, each of which was growing faster than the US or Europe.

In the fall of 2008, the curtain fell on this brief, shining moment in time as the economic downturn – which had been wreaking havoc in the housing and financial service sectors for more than a year – spread like wildfire to virtually every other industry and the resulting damage may take years to fully unwind.

Investors have understandably been shocked by horrific declines in asset classes from equity to real estate – and by the very real concern that they too could be at risk of losing their jobs. As a result, people are cutting back at every income level and, even in the face of this year's Stimulus, may not resume spending to any meaningful degree for many years to come. Indeed, I don't see how the Plan can have much of an impact on overall economic growth because most of the jobs being lost now no longer seem to be in those industries targeted. For example, it is unlikely to help the people getting cut from financial services, aviation, or defense and, more recently, Information Technology. In fact, some of our strongest industries, like defense, are actually being singled out for additional cuts under President Obama's 2011 balanced budget proposal. Where will these people find work and, if they do, at what wage? In these industries, people tend to have higher incomes and, by and large, are (or were) Prime borrowers when they first bought their homes. Given low savings rates and decimated equity portfolios, if these people cannot find work soon, Sub-Prime may spread to Prime and impact prices at the high end where workers in "shovel-ready" programs aren't shopping. Indeed, stubbornly high interest rates for Jumbo loans – and the recent proposal to reduce or eliminate the itemized deduction for

[1] This is a statement President Obama uses on frequent occasions
[2] World Economic Outlook, International Monetary Fund, September 2006

mortgage interest for those earning more than $250,000 per year – have already begun to have a chilling effect on high-end sales and listings.[3]

What I hope – through whatever tax breaks and job creation the Stimulus offers to industries like construction, alternative energy and transportation – is that it will soon ease the pressure on companies in other industries who are proactively slashing payrolls to reduce overhead and conserve cash to avoid running into trouble going forward. In my opinion, it is unemployment – not the banks or housing – that lies at the heart of our problems now. Low-end housing affordability has reached a record high and sales are already beginning to rise as first-time buyers – through a combination of lower prices and conforming mortgage interest rates – can finally buy in responsible fashion, with 20% down and a payment equal to 25% of their gross income.[4] The fix is – or soon will be – in for the troubled banking sector as the Term Auction Facility (TAF), Commercial Paper Funding Facility (CPFF), Troubled Asset Relief Program (TARP) and Term Asset-Backed Loan Facility (TALF) begin to have an impact. And I believe that the Fed and Treasury are on the verge of devising an acceptable plan that will be good enough to entice Private Equity back into the game and have a good chance of creating liquidity through a more efficient, secondary market for most of the assets that, for all intents and purposes, have been sitting worthless on bank balance sheets.

With regard to the TARP, I have listened to those who think (my fellow alum) Hank Paulson betrayed the public trust by switching gears and failing to restore liquidity to frozen assets as was originally intended.[5] I would argue that, in the midst of the tornado, he realized that these assets were far more complicated than anyone thought and that it would take far too long to create and establish the proper market mechanisms. He knew the clock was ticking and decided instead to inject cash directly into bank balance sheets by issuing preferred stock with a three-year term and charging the companies 5%. These were loans – not bailouts – and given the fact that the Government's cost of funds for maturities up to 30 years was less than 3.5%,

[3] NAR 4th Quarter 2008 Home Prices, published February 12, 2009, for homes in Santa Clara County
[4] "Pending Home Sales Down but Housing Affordability at Record," National Association of Realtors, Washington, March 3, 2009. The HAI indicates that a median-income family earning $59,800 could now afford a home costing $283,400
[5] Hank Paulson, Dartmouth Class of 1968; author, Dartmouth Class of 1978

these instruments have the potential to generate a substantial return on the taxpayer's investment.[6] In spite of the intense pressure from Congress to divert funds to the Auto- and other troubled industries, Paulson remained steadfastly focused on strengthening bank balance sheets, period – and his only mistake, in my opinion, was that he failed to then *resume* the necessary work of restoring liquidity to these frozen assets once the danger of a global, financial meltdown had been averted. He and Fed Chairman Ben Bernanke kept us from the Abyss and, by only using half of the allotted funds, they left the second $350 Billion for the new Administration to create and manage a program of their own design.

But everyone is so busy pointing fingers that many seem to be forgetting the role they themselves may have played in creating the crisis. As Jeremy Siegel points out in the most recent edition of his book "Stocks for the Long Run," the list of those responsible includes bank CEOs; Alan Greenspan and the Fed; Credit Rating Agencies; Fannie Mae and Freddie Mac; Mortgage Lenders; home buyers; and, last but not least, congress.[7] As far back as 1999, for example, there has been significant pressure from both the Republican and Democratic parties lobbying Fannie and Freddie to loosen their lending standards under the notion that every American had the "right" to own a home.[8]/[9] In any event, neither side seems willing to listen or compromise with the other.

[6] Due to the recent switch in emphasis to "Tangible Common Equity (TCE)," which excludes goodwill from a bank's capital, the Government has evidently decided to convert their preferred shares in Citi to common stock. I am not entirely clear with regard to the mechanics of this, since it seems to ostensibly reduce the Government's claim and seniority, but I imagine there must still be some provision for repayment. The 8% initial dividend, however, will disappear.

[7] "Stocks for the Long Run, 4th edition: The Definitive Guide to Financial Market Returns and Long Term Investment Strategies," by Jeremy Siegel, McGraw-Hill, November 27, 2007

[8] "Fannie Mae Eases Credit to Aid Mortgage Lending," Steven A. Holmes, The New York Times, September 30, 1999: "Fannie Mae, the nation's biggest underwriter of home mortgages, has been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people. In response, the Fannie Mae Corporation is easing the credit requirements on loans that it will purchase from banks and other lenders. This action will begin as a pilot program involving 24 banks in 15 markets and will encourage those banks to extend home mortgages **to individuals whose credit is generally not good enough to qualify for conventional loans**. Fannie Mae official say they hope to make it a nationwide program by next spring.

[9] Fannie Mae: Another New Deal Monstrosity," by Karen De Coster and Eric Englund, The Mises Daily, July 27, 2007. "In January of 2000, Fannie Mae introduced its 'Mortgage Consumer Bill of Rights.' This rundown of entitlements promised the consumer the 'right' to access credit and to qualify for the lowest-cost mortgage possible. After the collapse of the NASDAQ bubble in 2000, and the shock of 9/11, the Federal Reserve, under Alan Greenspan, came to believe that the United States was heading into a deep recession and that the prescription to reinvigorate the economy entailed creating more money and granting more credit. By June of 2003, Fannie Mae's outstanding Mortgage-Backed Securities grew from $706.7 billion to an astounding $1.3 trillion. On December 16, 2003, President Bush signed into law the 'American Dream Down-Payment Act of 2003,' which promised to help 40,000 families a year with their down payment and closing costs.

Economically, my clients know that I favor government non-involvement, low taxes, self-regulation and minimal barriers to entry. I believe that it is business, large and small – in a free-enterprise system driven by Supply and Demand – that creates most of the productive jobs which, in turn, help to generate growth in GDP. While President Obama's new budget proposal might reduce taxes for "95% of Americans," it does so largely at the expense of the 5% who have little vote or choice in the matter. As Michael Boskin says, "new and expanded refundable tax credits would raise the fraction of taxpayers paying no income taxes to almost 50% (and) would cement a permanent voting majority with no stake in controlling the cost of general government."[10] We should pause to remember the words of Alexis de Tocqueville[11] and the likelihood of serious, Unintended Consequences that could result from such policies In my opinion, if we increase the tax burden on the very corporations we're relying on for job creation in a global, highly competitive world – and on the individuals to whom our nation's charitable and social programs turn for donations – consumption and spending could contract and reduce, rather than increase, the funds available for the very programs Congress wants.

I agree that we need to work on a crumbling infrastructure like bridges and roads as the Stimulus intends. We need to work on transportation – hopefully on light rail like BART and other forms of mass transit that promise to relieve congestion on our crowded freeways, where people waste hours commuting to and from work, once and for all. We need work in every aspect of alternate energy – including batteries to store the energy once it is generated – and the safe disposal of nuclear waste. And we need to build out the electrical grid to distribute energy that is generated in the middle of the country from solar and wind to the coasts, which are the biggest users – and we need to make the electrical grid smarter. But, in my opinion, we also need to support business in general through less, not more, restrictive tax policies in

[10] "Obama's Radicalism is Killing the Dow," Michael J. Boskin, the Wall Street Journal, March 6, 2009.
[11] "Democracy in America," Alexis de Tocqueville, 1835 Volume I, Chapter XV: In America, the government is exposed to the whims of the majority – particularly in the legislature which, because it is elected at short intervals, must act on public opinion in order to stay in office. Furthermore, "the moral authority of the majority is partly based on the notion that there is more intelligence and wisdom in a number of men united than a single individual, and that the number of legislators is more important than their quality". This circumstance can give rise to what de Tocqueville called "the Tyranny of the Majority."

almost every industry from healthcare, to water recycling and desalination, to mobile- and high-speed telephony. We must not erect destructive trade barriers that will likely prompt retaliation from other countries and which, as a result, could hurt us more than they help. And we must reverse the mentality that seems to believe we can raise the cost structure of our companies to the point where they may be selling at a loss and think they will somehow "make up for it in volume." The only way, in my opinion, to keep us truly competitive and profitable in a global marketplace is to allow our country's innate entrepreneurial spirit to drive investment as unfettered as is reasonably possible and to resist the temptation to over-regulate.

The fact is that we desperately need to work together – to draw input and policies from both sides of the aisle – if we're going to stabilize things as quickly as possible so that people and companies may once more look more than three months into the future with a sense of confidence. Otherwise, as Nouriel Roubini has been saying, we are at risk of reaching unemployment rates as high as 12% and, long before then, it will be hurting people in higher brackets with greater consequence to our economy.[12] While it may be politically expedient for Congress to raise taxes on people earning over a certain amount, if these (formerly) well-to-do people are out of work and unable to spend, income and sales tax receipts could, in fact, fall, thereby defeating the very purpose of the increases.

As Jamie Dimon[13] said in a recent speech to the U.S. Chamber of Commerce, we must be incredibly careful now not to derail the gains we've made through ill-conceived actions we take today.[14] But, unfortunately, this does seem to be the way we're heading. From my perspective, it feels divisive and unproductive to tongue-lash our corporate leaders in on-camera testimony for hours on end for transgressions many of them did not commit. And, when we combine these sorts of actions with proposals to tax a relatively small and isolated class of successful people who represent the American Dream – and to hamstringing our companies with the triple threat of higher taxes, wages and healthcare costs to the point where they may

[12] RGEMonitor.com
[13] Chairman and CEO of JPMorgan
[14] "Dimon Says System Can Be Saved if Vilification Ends," Elizabeth Hester, Bloomberg.com, March 11, 2009: "If we act like a dysfunctional family and we don't finish these things and we're forever debating them, I think this will go on for several years. It's completely up to us at this point."

no longer be competitive in a global economy – I believe that we are standing on the edge of a precipice and, after a relatively brief recovery, that things may ultimately get worse. In any event, we must certainly prepare for this possibility.

As a country, we will be consumed for weeks and months to come with the many challenges on the financial, housing and employment fronts. Yet with the spending authority that global governments have committed to implementing on a coordinated basis, I believe we will begin to see at least initial improvement on the financial and housing fronts before year-end.

That's the good news.

The bad news, in my opinion, is that by the time we succeed, the demographic transition from a Spending to a Savings Cycle will not only have gripped 80 Million Baby Boomers as they near retirement – it may last as long as 8 to 10 years until the 78 Million "Millennials," who are only now entering college, have a chance to make *their* impact on GDP.[15] By now, all of my clients should be acutely aware of the impact that I believe this transition will have on our economy.[16]

Action-wise, throughout the balance of this year, I will stay focused on the stronger sectors and will continue to "leverage" these holdings through over-weighted allocations relative to the market with the expectation that, when we ultimately do get sustained rallies, our portfolios will be positioned to participate in a meaningful way. Also, as we await those rallies, it has become clear that the time-table for me to be able to hedge and to invest both long and short has been dramatically accelerated. At some point in the not-too-distant future, I must have the ability to address my concerns as they arise without being forced to make the black-and-white, sweeping decision to sell everything.

As we headed into 2008, and the housing and unemployment pictures were beginning to deteriorate, I wanted to protect the wonderful gains we had made the prior year. I wasn't sure how long the economy would be at risk; how bad it would get;

[15] "The Great Depression Ahead," Harry Dent
[16] "Demographics," Barnaby Levin, Citi Smith Barney, April 16, 2003

or whether there might be any collateral damage to industries otherwise unrelated. So I intensely considered, evaluated – but ultimately had to dismiss – any hedging strategies using options or inverse funds as viable means to effectively protect our portfolios overall or for any meaningful amount of time. By the fall, raising 30% cash like we did in the Emerging Market account, didn't help much either as we were still exposed due to the other 70%. In the end, even though my efforts to find an effective solution that would be permitted in a discretionary, fee-based account were utterly frustrated, there is one way that I believe would truly hedge a high-quality portfolio of core, blue chip stocks or ETFs that we simply don't want to sell going forward. That strategy is explained in a separate white paper that I have written titled "Short Against The Box."

As things stand, the purpose of this letter is to share my thoughts and opinions regarding the near-to-intermediate future – and to explain what I plan to do about it. It is also meant to initiate a conversation and to offer clients the opportunity to consider several possible, more creative strategies for preserving capital in volatile markets. I invite this discussion so clients are comfortable with whichever approach we ultimately choose to deal with the new realities that we will undoubtedly face over the course of the coming decade.

For now, however, "let me be clear." In my opinion, things are getting better at this time and we are making progress. Year-to-date, as the enclosed performance reports show, we have captured sizeable gains on an absolute and relative basis and, while there can clearly be no assurance going forward, I believe we are well-positioned to continue doing so. I believe that there are a number of actions being taken or proposed by Congress today that have the potential to make things worse as we head into 2010 and I am in the process of preparing for that eventually. And, finally, I want and need access to new tools and approaches as a portfolio manager so I can better address future challenges and, well in advance of this, am inviting discussion with my clients and my firm so everyone understands exactly what it is that I have in mind.

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