



## Buyout or Bailout?

Many people are currently asking themselves how and why the US investment and commercial banks got themselves and the American people into the current situation. Given the unprecedented events we are experiencing, and the colossal bail out plan being proposed by the Bush Administration, we thought addressing these questions would be appropriate.

## What is happening?

Large financial institutions make loans based on the equity that they have on their balance sheets. The larger their equity base, the more they can lend, and the higher their profits. Banks typically can lend out up to ten times (or more) the equity they have at any given time. This has allowed all of us to benefit from a credit system that allows money to flow to us in the form of cheap and readily available loans for homes, cars and credit cards. As an example, there is as much as \$14 trillion dollars in outstanding in loans for both residential and commercial real estate, even though financial firms have only a small fraction of this value on their balance sheets. Keep in mind that these numbers do not reflect all the money we borrow for credit card debt, and student and car loans.

This crisis has unfolded because banks made increasingly imprudent loans that were not properly priced, or adequately monitored. New accounting rules which came into effect earlier this year forced banks to revalue all of their loans to actual market value and because past regulation was lax in monitoring the value banks were placing on these assets (after all these banks had huge incentive to overstate the value of their assets) we ended up with banks drastically overstating their asset base. As these banks have had to restate down the value of all these assets, especially real estate loans, the banks have had to raise more capital to place as equity on their balance sheet, or cut back on the loans they are making by a factor of ten times. Firms like Lehman Brothers, Bear Stearns and AIG were not able to get this done quickly enough to avoid failure.

The domino theory is now in effect. With the failure of each bank there was a constant stream of re-pricing, and this placed other banks at risk, eventually leading to a lack of faith by banks in each other. And as it

unfolded, this led to a crisis in confidence (and pricing) on all credit. Since there are no buyers for the higher risk loans, the value of these loans has become impossible to price, and invariably firms keep marking down the value of these loans and the banks have to keep raising more money or making fewer loans (to all of us). As a consequence a credit crisis cycle is unfolding. It is important to remember it is not just the banks at risk; it is the whole system we are all dependent on and that all of us rely on.

Why the bailout?

Despite the name, this is not a bailout; our government is proposing to buy these assets at a discount, not giving away money. The proposed \$700 billion bailout would enable the government to purchase these loans that nobody wants or knows how to value from banks for a discount and free up the banks to continue to make the loans which we all rely on. The hope is that this plan will quarantine the crisis and allow for the free flow of funds across financial institutions and to all of us too.

### **What will it cost taxpayers?**

It all depends on what the government pays for these loans. Bill Gross, the leading fixed income manager in the world, analyzed that if the government pays 65 cents on the dollar, it is quite possible that the US taxpayer will make money with this plan (Washington Post Sept. 24, 2008). How is this possible? The government's cost of capital is only 3.8%; however, the mortgage owners are paying as much as 7% on their loans (and remember these are loans with collateral, the collateral on all these loans are the homes that people bought with the money). When you factor in that the mortgage loans are receiving interest on 100% of the loans, even accounting for defaults and bad loans, because the government might pay a 30% to 40% discount, and recover a reasonable amount from repossessed homes, it is quite conceivable these assets can be sold for a meaningful profit at some point. Again, the government is not giving the money away; they are seeking to buy these assets for a discount and then they plan to re-sell them.

The price paid for these loans will determine what it costs US taxpayers, but it could turn out to be a net gain for taxpayers.

## Is it good policy?

This whole mess is incredibly unfortunate because had we regulated and monitored these banks more carefully we could have avoided this dilemma. It's also true that over the past few years our country would have grown more slowly, home prices would never have climbed so high so fast and tax revenues would have been less for the government. **There was no-one with an incentive to slow things down.**

It's not our place to criticize the government, so let's be clear that **we have no choice but to straighten this mess out or all forms of loans will be cut back drastically and our economy would choke.** Every US citizen would pay for a truly dreadful outcome. This plan is not a choice, and it might not be the end of the process. The fact is we are now addressing the root of the problem and we will fix it as a country. The US, like any country, makes mistakes. How we are different is that we confront our challenges and address them head on. It took too long to build a plan, but this is the first crucial step on the road to recovery.

What's next?

This situation almost certainly will slow the economy, but that is why the world's stock markets already have fallen so much this year. It is also true **that as soon as there is a sense that we have really addressed this credit issue, we can then expect a healthy environment for all investors.** The economy will still look bleak, but the market will act many months before the economy shows signs of recovery. We are highly confident with what this plan will mean for all investors.

We believe that a year from now we will still be dealing with the implications of this process. However, it will be with a more optimistic perspective than where we are today. As such we believe that, regrettable as this all is, we are simply paying now for the excesses of the past. More importantly, **we believe a year from now the US markets will be less risky, and that they will have better prospects than they have had for some time.** It is no coincidence that one of the most respected investors of our time, Warren Buffet, invested \$5 billion dollars into Goldman Sachs at the peak of the crisis. Buffet is famous for saying that **investors make money when fear is rampant, and it has never been as rampant in many of our investment lifetimes as it is now.** It is of little solace to focus on opportunity when fear is so prevalent, but it is also true too that only then is

opportunity really available to everyone. There will be unique opportunities for all of us in these unusual times.

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Thank you for your trust and confidence,

Kelly Trevethan, CIMA®  
CEO & Managing Director

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