

October 15, 2008

COMMENTARY

Instead of our usual summary describing what occurred in the quarter and how stocks and bonds performed, we are taking a different approach. We keep getting asked the question "What caused the credit crisis that is crippling banks and dragging down global growth?" We have attempted to identify the conditions that led to the housing bubble and ultimately to the credit crunch that has frozen liquidity and put a damper on global economic growth.

Stock prices surged to meteoric highs during the late 1990's as technology and telecom companies were projected to earn huge profits well into the future. As we all know, the technology and telecom bubble burst in 2000 and continued to deflate for over three years. The S&P 500 Index declined approximately 43% between the beginning of 2000 and the first quarter of 2003. The Federal Reserve attempted to prop up the struggling economy and stock market and dropped the Federal Funds rate from 6.5% at the beginning 2000 to an all time low of 1.0% by mid 2002.

Between the end of 1999 and 2002, real estate proved to be one of the few asset classes providing positive returns. The Wilshire Real Estate index increased by over 50% during the period and the median home price increased by over 30%. This dramatic increase did not go unnoticed by investors dealing with falling equity values and investment banks looking to replace billions of dollars of fees generated from technology and telecom initial public offerings.

A combination of low interest rates and large inflows of foreign funds led to easy credit conditions. Banks, which historically originated and held mortgages, were finding it more lucrative to originate and distribute mortgages, along with the credit risk. Buyers of mortgages would typically put them in a pool (fund) and sell the interests to other parties. The securities purchased were termed mortgage backed securities (MBS) and collateralized debt obligations (CDOs).

Housing prices continued to climb at double digit rates in 2004 and 2005. During this period, home ownership increased dramatically. By 2004, home ownership reached an all time high of 69.2%, well above the long term average of 64.0%. Speculators were drawn into the market and at the top of the housing bubble nearly 40% of homes purchased were not primary residences. Home builders, responding to an insatiable demand for homes, were purchasing property and building as quickly as possible.

Lending standards dropped dramatically during 2004 and 2005 as defaults were very low and even if the property was returned it was assumed it could be sold quickly, perhaps at a profit. Lenders began focusing on volume rather than default risk. To meet a growing demand for MBS and CDOs, lenders stretched their lending criteria to unreasonable levels. Loans to less than credit worthy borrowers were categorized as subprime. A total of \$600 billion of sub prime loans were made in 2006, up from \$160 billion in 1999. Many of these subprime loans came with adjustable-rate mortgages that allowed the borrower to pay interest only, often times at a very low introductory rates. The interest rates reset to higher levels in the future, but most borrowers assumed they could refinance and lock in lower rate after the property appreciated and they generated equity.

MBS and CDO buyers included pension funds, banks, mutual funds, hedge fund, Fannie Mae and Freddie Mac, as well as foreign governments. Most buyers believed that the securities were fairly safe and secure and they looked at historically low default rates and high credit ratings to validate their purchases. In addition, interest rates on other fixed income securities were very low and mortgage backed securities offered higher yields. Buyers often used the securities for

collateral to borrow and purchase even more MBS and CDOs. Not only were the buyers purchasing more securities, they were increasingly using borrowed funds and putting in less of their own money (leverage).

The credit rating agencies typically gave the securities' investment grade ratings, implying the likelihood of default was fairly low. In many cases, the issuer purchased credit default insurance, which was supposed to guarantee payments in the event of borrower defaults. This was one of the primary reasons that the credit agencies so willingly handed out investment grade ratings.

As seems to be the case with bubbles, eventually supply exceeds demand. Overbuilding during the first part of the decade led to a surplus of homes and prices began declining in the summer of 2006. Once home prices started falling, refinancing opportunities quickly disappeared and defaults increased dramatically as borrowers couldn't handle higher mortgage payments after interest rates reset to higher levels. Many home owners that purchased at the peak of the housing boom faced negative equity, which caused an ever increasing number of owners to simply walk away and face foreclosure. Falling home prices, rising interest rates, and tougher lending standards pushed default and foreclosure activity to levels not anticipated. Foreclosure activity accelerated in late 2006 and during 2007, nearly 1.3 million houses were subject to foreclosure, a 79% increase from the prior year.

In 2007 losses mounted for mortgage related securities. Many securities were downgraded after losses were well beyond expectations and the default swaps proved worthless as the issuers themselves became insolvent. In essentially a perfect storm, the value of mortgage securities quickly declined and sellers were finding little if any interest from would-be buyers. Buyers that used leverage were forced to sell securities in order to satisfy their lenders. In many cases, they had to sell non-mortgage securities because there simply wasn't a market for MBS and CDOs. The forced selling pushed prices down prices in many non-mortgage related asset classes and expanded the impact of the mortgage credit crises.

Many banks, hedge funds, and other financial institutions found themselves short on cash as they were being forced to reduce leverage. Lenders became increasingly leary to lend to institutions that were holding mortgage related securities for fear they might not get their money back. The fall of Bear Stearns in March of 2008 was an indication of how quickly such securities could bring even a large firm to its knees. Without government intervention, Bear Stearns would have been forced into bankruptcy. During the third quarter of 2008, Lehman Brothers, AIG, and several other high profile financial firms were also forced into bankruptcy or needed government assistance to survive. Financial institutions hoarded cash, making it more difficult for institutions to access credit and borrowing costs, assuming you could borrow, jumped to historically high levels. This brings up to where we are today.

In response to this situation, the U.S. Government, along with the Federal Reserve and Treasury, has implemented several policies designed to increase credit access. In addition, governments from around the world have also tackled the credit problem with their own policy actions. The current credit crisis has exposed structural issues in the global financial system. Consequently, investors have lost confidence and trust in Wall Street and corporate America. This loss of confidence is a major contributor to the "fear" that is strangling the equity and credit markets.

MARKET OUTLOOK

The outlook for both stocks and bonds is very cloudy. The credit freeze has forced many companies to postpone purchases and focus on improving operational efficiency and cutting costs. As a result, capital expenditures have declined and layoffs have increased. The length and depth of the credit freeze is still unknown. If credit conditions improve fairly shortly, the slow down in economic growth may be modest and fairly short in duration. However, if credit problems persist, we could see a much deeper and longer economic slowdown. At this point we are optimistic that the intense efforts of the U.S. government as well as governments around the

world will begin to heal the broken credit markets fairly soon. However, stocks and bonds are primarily trading on fear and uncertainty, as noted by the intense daily stock market volatility and historically high credit spreads on most bonds outside of Treasuries.

These are especially trying times and we appreciate your confidence and patience as we navigate these difficult markets. More than ever we continue to work diligently on your behalf to achieve your investment goals. Please call us if you have any questions.

Very truly yours,

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