



WEALTH DIMENSIONS

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Stimulus on Steroids

So much has happened in the first quarter that it seems like ages ago when Barack Obama was sworn in as the 44th President of the United States. His presidency was quickly greeted with the largest January-February decline in the stock market this century only to be followed by the largest four week gain since 1933. For the quarter, the S&P 500 finished down 11.01% - a whopping 49.5% below its October, 2007 high¹.

With the crisis deepening, the politicians in Washington have been busy creating program after program in an attempt to stimulate the economy and remove roadblocks to recovery. The President introduced his 2009 budget to Congress with a staggering deficit estimate of \$1.8 trillion, over 12% of Gross Domestic Product. The Federal Reserve, Treasury Department and the FDIC have been working to coordinate their efforts to stabilize financial institutions, both domestically and abroad. The current Fed and Treasury programs now exceed \$2 trillion dollars in various forms of bailout and stimulus, with estimates of an additional \$1 trillion needed over the next twelve months.

At the recent G-20 meetings, President Obama was unsuccessful in convincing foreign leaders to commit to the same levels of government intervention in their own free markets. There is a growing philosophical debate between those who believe that markets will naturally correct imbalances versus those who support government intervention to lessen the pain and influence outcomes, with the Obama administration clearly falling into the latter group. Let's examine two of the latest government incursions into the free markets and the wisdom of doing so.

Mark-to-Market

Mark-to-Market accounting is the act of recording the price or value of a security, portfolio or account to reflect its current market value rather than its acquisition price (book value).

Senator Paul E. Kanjorski (D-PA) led a charge from Congress to successfully pressure the Financial Accounting Standards Board to suspend mark-to-market accounting to relieve banks and others from the pressure of valuing their assets at the prices they are currently selling for in the market.

Their arguments center on the belief that an outstanding mortgage is worth its full face amount to the bank as long as the borrower is currently making mortgage payments. The logic behind mark-to-market assumes that a buyer of the mortgage evaluates the probability of collecting all of the future interest and principal payments in determining the price he is willing to pay to buy the mortgage.

Opponents of mark-to-market argue that it is not fair to force banks to value these assets at “pawn shop prices” based on distressed sales. Proponents and generally accepted accounting standards have maintained that the market price most accurately reflects the current risks of the asset and prices them accordingly. If the price is too low, a seller will not sell the asset and priced too high, a buyer will not buy.

Suspending mark-to-market will artificially improve earnings and capital levels at banks, but simply pretending that all these mortgages will be repaid does not solve the underlying problems. It may make some banks appear solvent longer, but when they ultimately do fail, the losses will be that much greater. In the meantime, solvent institutions are deprived of capital as more funds are siphoned off into insolvent “too big to fail” institutions - hiding their toxic assets behind rosy assumptions and phony marks. Japan experienced this dynamic for years by allowing zombie banks to linger on for more than a decade.

The New Government Hedge Funds

Treasury Secretary Tim Geithner recently announced his new program, the Public Private Partnership Investment Program. The purpose of the program as stated by the Treasury is:

To cleanse bank balance sheets of troubled legacy loans and reduce the overhang of uncertainty associated with these assets, the Federal Deposit Insurance Corporation and Treasury are launching a program to attract private capital to purchase eligible legacy loans from participating banks through the provision of FDIC debt guarantees and Treasury equity co-investment.

In a nutshell, this program creates a leveraged hedge fund with debt guaranteed by the FDIC at a ratio of 6-to-1 thus promoting the private sector purchase of Toxic Assets to remove them from bank balance sheets. The following is an example of this program directly from the Treasury Department Press Office:

- If a bank has a pool of residential mortgages with \$100 face value that it is seeking to divest, the bank would approach the FDIC.
- The FDIC would determine that they would be willing to leverage the pool at a 6-to-1 debt-to-equity ratio.
- The pool would then be auctioned by the FDIC, with several private sector bidders submitting bids. The highest bid from the private sector – in this example, \$84 – would be the winner and would form a Public-Private Investment Fund to purchase the pool of mortgages.
- Of this \$84 purchase price, the FDIC would provide guarantees for \$72 of financing, leaving \$12 of equity.
- The Treasury would then provide 50% of the equity funding required on a side-by-side basis with the investor. In this example, Treasury would invest approximately \$6, with the private investor contributing \$6.
- The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis – using asset managers approved and subject to oversight by the FDIC.

What we find particularly concerning is the program requires taxpayers to invest half of the equity investment and the FDIC will guarantee the debt of the new fund creating a 12:1 leverage ratio for the private investor. For every dollar of equity investment by the private investor, 13 dollars of taxpayer money and FDIC guaranteed loans are provided.

According to John Hussman, PhD, this is a recipe for the insolvency of the FDIC and an attempt to bailout bank bondholders using funds that have not even been allocated by Congress. The whole plan is an abuse of the FDIC's balance sheet, which exists to protect ordinary depositors, not bank bondholders. Ironically, it will be the same investment banks that participated in the shadow banking system that contributed to the demise of our financial system that will now receive FDIC insured loans to bail it out. Citigroup, Goldman, JP Morgan and others will be permitted to participate in this program and swap each other's toxic assets by putting up a small percentage of their own money, while taxpayers bear over 90% of the downside risk.

Where do we go from here?

As we mentioned in our last quarterly letter, there remains a monumental struggle between deteriorating economic conditions and fiscal and monetary stimulus like the ones we discussed above. While we are relieved that the panic we witnessed at the beginning of 2009 has subsided allowing the market to make a reasonable rebound, we expect continuing challenges from the backdrop of rising unemployment, falling real estate prices from resurging foreclosures, and consumer retrenchment. The Paradox of Thrift is alive and well and even our new President is encouraging us to sacrifice responsible personal behavior for the sake of the economy. Peter Schiff highlighted the President's comments at the recent G-20 summit in London:

President Obama urged Americans not to let their fears crimp their spending. It would be unwise, he argued, for Americans to let the fear of job loss, lack of savings, unpaid bills, credit card debt or student loans deter them from making major purchases. According to the president, "we must spend now as an investment for the future." So in this land of imagination (where subprime mortgages are valued at par), instead of saving for the future, we must spend for the future.

The federal government is participating in the same type of behavior by sacrificing its balance sheet in an attempt to alter the outcome of the recession. We are potentially headed down a slippery slope of socialism as government policy attempts to selectively redistribute wealth. Recent statistics indicate that over 40% of Americans pay no federal income tax, so the political will to restore free market activities could be met with significant resistance in the future.

I guess Ben Franklin had it wrong - apparently a penny spent is a penny earned.

Is Diversification Dead?

We are confident that the economy will eventually recover with or without stimulus, but the process will be drawn out and erratic. The problems that led us into this mess developed over many years and the markets will take time to work through these issues. It is pretty clear that the powers in Washington are in uncharted waters and are experimenting with untested policies that will have unintended consequences.

In times like these, many investors begin to question time-tested investment principles like diversification as media pundits spread misinformation about its validity to attract an audience. What these pundits should be examining is whether diversification is being used appropriately. Proper diversification is always prudent, if for no other reason, than to mitigate the risk that all assets in a portfolio will decline together.

In our experience, diversification breaks down because a portfolio is not actually diversified. We frequently encounter portfolios where an investor owns many assets, but is still not diversified. Contrary to common misconception, diversification is not accomplished simply by holding a large quantity of investments in a portfolio, it is the behavior of those assets relative to each other in different economic environments that creates diversification.

Diversification is also misrepresented as a technique to always avoid significant declines in portfolios that hold a high percentage of risk assets. As history can attest, there are occasional time periods when there is so much financial stress on global markets that normal correlations *temporarily* fall apart and virtually all risk asset classes move down together. The first quarter of 2009 is an excellent example of such a period.

In order to truly diversify, a portfolio must have both risk assets and risk-free assets. Risk-free assets hold their value in periods of high financial stress, reduce the volatility of the overall portfolio, and provide capital to purchase risk assets at depressed prices.

Over the long run, there is no prudent substitute for a properly diversified portfolio tailored to an individual's tolerance for risk. Opportunists, in collaboration with the media, try their best to lure investors into thinking there is a magic black box offering low risk and high returns if we just know where to look. The reality is that risk and reward are related and investors should focus on proper diversification and the efficient exposure to risk.

Thank you for your continued confidence in our services.

Wealth Dimensions Group, Ltd

¹ www.standardandpoors.com

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