

September 30, 2008

Bailouts, Crashes, and Panic

A lot happened during the third quarter of this year, and almost none of it was good. To recap the events of the past few weeks: A segment of our financial sector has been nationalized; we suffered the largest one day drop in the stock market since the crash of 1987; the credit market completely seized up; and investments that were rock solid a month ago have suddenly become very shaky. The rapid worsening of the financial crisis has thrown all of the capital markets into disarray and threatened to spill over into all segments of the economy. We will discuss the scope of the problem and what we think should be done about it, as well as what we think investors should do and not do in response to these extraordinary events.

We have talked in past letters about the housing bubble and the subprime mortgage problems. It initially appeared that the problems were confined to the subprime market, but these problems quickly expanded into a full blown credit and liquidity crisis that has affected leveraged holders of all assets. This lack of liquidity and credit has led to rapid write downs in asset values and an inability to raise the necessary capital to make up the difference. This is how we can go from having well capitalized companies to bankrupt companies literally over night. We have been seeing a classic run on the bank as investors try to dump securities where there is no market, causing prices to tumble.

There has been a lot of discussion, as there should be, about whether the government should bail out these troubled financial companies. It is important to note that when credit markets seize up, all financial firms are in danger. It seems clear that nobody would benefit from a collapse of our financial sector and most people agree that something needs to be done to prevent it from happening. Unfortunately, with the election a month away, politics has been thrown into the mix. Political posturing from both sides of the aisle has added to the violent market swings we have seen over the past few weeks. Predictions of economic doom and depression have been thrown around by everyone from the President on down. This, frankly, does little to calm the nerves of already skittish investors.

The one big difference in this crisis from others we have seen is that bond investors, normally immune from large losses, have been hurt right along with stock investors. The liquidity in the credit markets has literally gone away, making it almost impossible to sell bonds. The only investment drawing any money is the U.S. Treasury market, resulting in T-bills, the world's safest investment, actually returning negative yields on two separate occasions during September, an unprecedented occurrence. While we expect volatile times in the stock market, this seizing up of the bond market has been the most unnerving event for us. At this point, there is very little to do until things in the market calm down.

The question has come up a lot recently about who is to blame for this crisis. There are lots of fingers pointing at lots of culprits. It seems to us that assigning blame at this point in time is like Captain Smith pointing fingers as the Titanic sinks from beneath him. There will be plenty of time later for the blame game. Right now we need to work on a solution to the problem. Suffice it to say that there is lots of blame to be shared by everyone. We can blame the politicians; we can blame the Wall Street investment banks; we can blame the millions of people that bought homes they could not afford at inflated prices. Investors were happy to buy mortgage debt as long as it yielded higher returns than more secure bonds. Rating agencies assigned high ratings to mortgage securities based upon faulty assumptions. The blame falls on many rather than a few. We should expect much more regulation in the financial sector when the dust settles.

What should we do now? This is a very understandable question that we have gotten a lot over the past few weeks. It is very difficult to think clearly when it seems like things are crashing around you. It is important to know that money is never made when you sell your investments when panic selling is going on around you. Successful investors do not change their investment goals based upon a reaction to market movements. Valuations in the stock market are at their lowest level in years, so from that standpoint stocks are a great buy at these levels. We will need to see some type of resolution to the current financial crisis, however, before we see a sustained rally. Bonds will also improve once the credit markets thaw out. This crisis will pass, as they always do, although it is impossible at this point to know if the worst is behind us or in front of us. We do know that it is impossible to correctly time the market. While it is always good to reassess our risk tolerance, selling into this market is almost guaranteed to be the wrong decision.

We welcome your calls in times like these. Please feel free to call us to discuss your investments and review your portfolio.

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