



Quarterly Memo

October 2008

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The Panic of 2008



In the fast changing world of today, the risk of a newsletter is that it will be obsolete by the time you read this. If there have been any significant changes, we hope they are for the better.

Trying to concisely explain the credit crisis and the plunging equity markets is a nearly impossible task. Recently I was asked at the family dinner table to explain the financial market "mess". Starting with subprime loans, mortgage securitization, credit default swaps, and counterparty risk, I moved on to CMO's, Bear Stearns, Fannie Mae, Freddie Mac, Indy Mac, Lehman Brothers, WaMu, AIG, Merrill Lynch, and

Wachovia. As I was getting into the Congressional debate over the TARP package provisions, my wife interrupted me "It's been 51 minutes and we still don't understand. You haven't made anything clearer."

With all its moving parts, it's no wonder that this situation is difficult to explain. Earlier this year, I

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Is this another 1929?

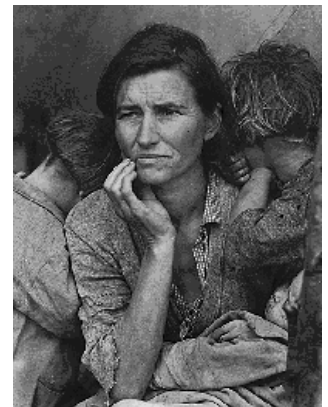
Living through the Great Depression made an indelible impact on a generation of Americans. My mother's experiences were typical: homeless people begging for food at the back door (they were never turned away) and the local bank failing, costing many neighbors their life savings. Unemployment reached 25%, industrial production fell by half, and the stock market lost a staggering 91%. With many current events being noted as "the worst since the Great Depression," are the

comparisons valid? Are we headed there again?

Like most all human disasters, the Great Depression was a confluence of factors, each of which independently could not have caused such a staggering outcome. But taken together at the right time, they magnified the effects of each other in previously unimaginable ways. (For a very readable discussion, get a copy of Galbraith's, *The Great Crash of 1929*.)

Mark Twain's famous line is "history may not repeat itself, but it rhymes a lot". Besides the ever present fear and greed, some

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“...such systems defy human ability to comprehend solutions due to complex interdependencies and changing and conflicting requirements.”

heard Lt. General Paul K. Van Riper (USMC Retired) speak on *“How to Be in Command When You’re Not In Control”*. The most memorable portion of the talk was a discussion of how the world can be divided into linear systems and non-linear, interactively complex systems. Linear systems may not be simple but produce very predictable outputs for a given input. For example, your car is a linear system. Although the car contains very sophisticated electrical and mechanical systems, when you turn the key or press the accelerator in your car, the result is highly predictable. Such systems can be studied and learned.

Contrast this to a complex, non-linear system. General Van Riper used the term “wicked problems”, originally coined in 1973. The term is used not in the “evil” sense, but in that such systems defy human

ability to comprehend solutions due to complex interdependencies and changing and conflicting requirements. Attempting to solve one aspect may only create new, unanticipated problems. The world’s political system is a wicked system. A 1914 assassination in Bosnia launched a sequence of unforeseeable events that plunged the world into a catastrophic global war and arguably a second, costing millions of lives. Is there any doubt that the economy is a “wicked system”? The monetary authorities of the world’s developed countries are struggling to grasp what inputs to apply when the outcomes are unknowable. It’s not that they are necessarily incompetent or ignorant folks – they are dealing with multiple, interrelated problems of mind numbing complexity. A strategy that seemed more than sufficient may appear wholly inadequate a short time later. Changes in the

nature and magnitude of policy responses are to be expected.

So how did we get to this point? Most of us know it began with subprime lending. We had one experience with a government clean-up of poor lending practices in the 1980’s with the S&L crisis. Congress created the Resolution Trust Corporation in 1989 to close down insolvent thrifts that had made bad loans at a cost of \$150 billion. This time is different in many ways.

Earlier this decade, the world was awash in liquidity – money looking for a place to be invested. Interest rates were low, however mortgage securities offered decent yields. Mortgage pools have been around for years, e.g. GNMA pass through securities. So had subprime lending, offering high interest rates, but it was a tiny part

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Thank you, clients!



In stressful times like now, some people need to vent their frustrations. Occasionally we are on the receiving end of the venting. That’s OK – we’re big boys and girls and we understand the mental and emotional stresses that chaotic markets can cause. Yet

many clients have kindly sent us messages asking how we are doing and letting us know of their support during these frightening times. We are so very blessed with outstanding clients – some of the finest people on the planet. Thank you for your confidence in us!

Remember our personal funds are invested alongside yours and the firm’s revenue is directly affected – we feel your pain, too. This is a learning and character building experience – and, like you, we’ll be glad when the lesson is over!

"I can't afford to lose it all!"

There's no emotion more powerful than fear. It has been in abundance lately, leading many people to think irrational, illogical thoughts, such as "at this rate, my account will be at zero in a few months!"

As difficult as it may be, let's push back the dark clouds and examine the facts:

1) Avoiding individual stocks eliminates the chance of total loss. The media love to say "retirement savings have been wiped out!" Only if you had invested in Lehman Brothers, Washington Mutual, Indy

Mac, Freddie Mac, or Fannie Mae. You can avoid the risk of total loss by having a well diversified portfolio.

2) This country has never had its equity market go to zero. Even in the Great Depression, a patient large stock investor would have recovered all losses by 1940.

3) Looking under the hood of a "typical" Matrix portfolio, you would find these top positions, with none over 1%:
eBay
Dell
AES (an electric utility)
Amazon.com

Google
Liberty Entertainment
Chesapeake Energy
Aetna
DeVry
Forest Oil

While they may suffer in a recession, it's just inconceivable that all of these companies would become worthless. Such a scenario would imply your best investment would be a reliable firearm, as it would be the end of civilization as we know it.

So when the fog of fear spreads over your thinking, take a deep breath and ask "am I thinking logically?"

"You can avoid the risk of total loss by having a well diversified portfolio."

FDIC insurance coverage – a primer

Congress recently expanded the FDIC coverage limit to \$250,000 from \$100,000. This should help many bank customers avoid having deposits at risk or spreading deposits among numerous institutions.

Knowing the FDIC's coverage rules and appropriately titling accounts can possibly result in multiple coverage amounts. The main coverage categories are:

1. Single accounts – one \$250,000 amount per person per bank.
2. IRA, Keogh, SEP, SIMPLE, self-directed

- 401(k) accounts - one \$250,000 amount per person per bank.
3. Joint accounts – if each owner has full withdrawal rights, then each owner gets one \$250,000 amount for all jointly held accounts.
4. Revocable trusts and payable on death accounts – each qualifying beneficiary gets one \$250,000 amount.
5. Irrevocable trusts – usually limited to one \$250,000 amount.
6. Employee benefit plans - \$250,000 for each participant's non-contingent

- interest in the plan.
7. Corporation and partnership accounts - one \$250,000 amount per entity per bank.

With no bank that can be considered absolutely safe, keeping FDIC coverage in place for all bank deposits is highly recommended.

Another alternative is the CD Account Registration Service (CDARS) available through many banks. This allows large CD amounts to be spread among many participating banks, providing multiple \$250,000 coverage amounts with the convenience of one account.



“Only a few voices sounded any alarm about the too rapid rise in home prices and the explosive growth in loans made to borrowers with poor credit scores and little equity in their homes – uncharted waters for default rates.”

The Panic of 2008 (continued from page 2)

of the mortgage market. Creating a pool of subprime mortgages could be done, but it wouldn't be very salable in the institutional markets without an investment grade rating. The credit (blame) for devising a solution is given to Bill Demchak and a small team at J.P. Morgan. By subdividing the pool into payment tranches (Tranche A get the first principal payments, then B, then C, etc.) a large portion of the resulting residential mortgage backed security (RMBS) can be turned into something the rating agencies will bless with an AAA, AA, or A rating. Voila – you have turned lead into gold – and a hugely profitable business.

What about the less desirable BBB or lower tranche? No problem. Create a new security out of it (collateralized debt obligation – CDO) with its own set of payment tranches – most of which would get a high rating. More gold out of lead.

For a while the party was a blast. Institutions loved the “safe” higher yielding securities and bought them by the billions. The investment banks made nice profits creating the RMBS and CDO's. The rating agencies had nice incomes from rating the securities. The mortgage brokers had a supply of

mortgage funds that could be loaned to almost anyone, meaning more loan closings and fat origination fees. Appraisers had plenty of work, provided they produced the right numbers. Home buyers could qualify for most any home they wanted simply by stating their unverified income. With the demand created by these new buyers, prices rose rapidly in many markets, further fueled by speculators (flippers) drawn into the fray for quick bucks. Homebuilders and realtors worked frantically to satisfy the demand. Only a few voices sounded any alarm about the too rapid rise in home prices and the explosive growth in loans made to borrowers with poor credit scores and little equity in their homes – uncharted waters for default rates.

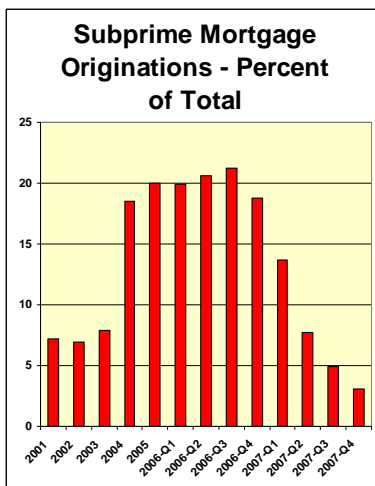
At the peak of the credit markets in 2006, more and more loans became securitized into “asset backed securities” or ABS. These included student loans, credit card debt, and leveraged buy-out loans (“collateralized loan obligations” or CLO's).

Enter the “Structured Investment Vehicle”, or SIV. These were entities created to invest in RMBS and CDO's using leverage, i.e. borrowed money. These typically borrowed short-term money in the commercial

paper market which had to be renewed every few months to finance the portfolio. Using the portfolio as collateral, they would often lever up to 10, 20, or even 30 times the investors' equity. Using the spread between the RMBS yield and the short-term borrowing rate magnified by the use of leverage produced great returns. For example, you create an investment account with \$1 million and you borrow an additional \$9 million at 2% interest. You take the \$10 million and invest it in a RMBS paying 6%, or \$600,000 annually. Paying the loan interest of \$180,000 leaves a \$420,000 profit. That's a tidy 42% return on your \$1 million investment. Not only did SIV's operate like this, but so did hedge funds and the investment banks with their own portfolios.

That may sound like a risky loan, but the market came up with a solution – credit default swaps or CDS. The lender could insure the \$9 million by paying the equivalent of an insurance premium. If the borrower can't pay, the lender turns to the counterparty on the CDS to collect. This unregulated, nonpublic market grew to \$54.6 trillion and is blamed for encouraging risk taking. You don't have to be a

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lender to buy them, so they have become vehicles to speculate on the downfall of any number of companies. What was intended to spread risk around ended up creating new risks.

Then the music stopped. Default rates on subprime mortgages zoomed higher and faster than anyone expected. Option ARM's generated in 2003-2004 reset in 2006-2007 at higher rates. Homeowners who had stretched to make the initial low payments couldn't handle it. Real estate values stalled, then began declining in many markets. Homeowners who had purchased homes with near 100% financing found themselves underwater before long. Higher than expected default rates coupled with declining home values (leading to reduced foreclosure recoveries, if any) quickly made the lower tranches in RMBS worthless – it was mathematically impossible to ever get paid back! The credit quality and values of the higher rated tranches became highly suspect.

Leveraged SIV's were some of the first casualties. If the right side of your balance sheet consists of 5% equity and 95% debt, a 6% decline in the value of your assets renders you insolvent.

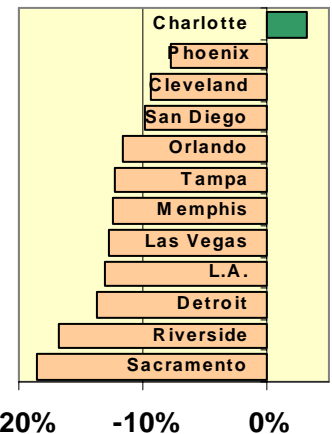
It's probably worth inserting here a discussion of "mark to market" accounting. (If in doubt, blame the CPA's!) The Financial Accounting Standards Board issued Statement No. 157 "Fair Value Measurements", which became effective after November 15, 2007 and essentially required an asset to be carried at its current market bid price regardless of the intended holding period for the asset. In the case of RMBS and CDO's the result has been massive write-downs as each sale at a lower price causes more write-downs leading to even lower prices.

Ever wonder why so many mortgage companies went bankrupt in 2007? The mortgage companies depended upon a steady stream of fresh money from the RMBS market. They took the raw material of money, turned it into mortgages and then sold them to the RMBS creators at a profit. At the onset of the problems, the investment banks' appetite for subprime mortgages waned. To move the mortgages off their books, the mortgage companies had to resort to discounting their inventory to move it off the shelves. Getting 98 cents on the dollar times billions of dollars adds up. Secondly, the buyer of a mortgage generally has the right to put the

mortgage back to the originator (i.e., get their money back) if the mortgage defaults within 12 months, as that is an indication of sloppy underwriting by the originator. Many smaller originators blew through credit lines quickly when this happened and ended up bankrupt and out of business.

By the spring of 2007, lenders to hedge funds and SIV's began to withdraw their financing as they became increasingly worried about the value of their collateral. Many of the lenders had RMBS and CDO's on their own balance sheets and knew of the problems first hand. To pay back their loans being called, the hedge funds and SIV's began trying to sell their RMBS and CDO assets, which served to only exacerbate their declining prices. Ironically, "good" RMBS with few defaults were hammered as the hedge funds had to sell their most liquid positions to raise cash. As the deleveraging train picked up speed in late summer 2007, we saw the curious effect of high quality stock prices fall (as the hedge funds had to unload them) and the prices of low quality companies rise (as the hedge funds had to buy their shares to cover short positions). To make matters worse, hedge fund and SIV investors

Home Price Changes 2007-2008



“Getting 98 cents on the dollar times billions of dollars adds up...”

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Is this another 1929? (continued from page 1)

similarities between now and 1929 include:

- The crisis was preceded by a time of prosperity when wealth could be created quickly and apparently easily. In the late 1920's, the stock market had created large fortunes based on paper profits.
- The widespread use of margin loans to buy stocks is widely believed to have exacerbated the downturn as stocks were sold indiscriminately to meet margin calls. Today, financial institutions and hedge funds with highly leveraged balance sheets are blamed for much of the current pain.

We have seen lately that improbable events are not the same as impossible events. However, we believe the odds are this is not another 1929, as there are significant differences:

- Between 1929 and 1933, 10,763 of the 24,970 banks in the US failed with huge losses. When IndyMac Bank failed, 97% of deposits were covered by FDIC insurance. With most failing banks, the FDIC has stepped in and negotiated takeovers with no depositor losses. There has been no run on the banks to any significant degree. No bank holidays have

been needed this time around.

- The protectionist Smoot-Hawley Tariff Bill, enacted in mid-1930, is widely credited with turning the US recession into a global depression by cutting world trade. US imports fell by 66% and exports fell by 61% as other countries retaliated by also raising tariffs. Today, goods and capital move freely across national borders.
- Federal Reserve monetary policy was ineffective or counterproductive. In 1928, the Fed raised rates to curb speculation and again in 1931 to support the dollar. The money supply was allowed to decrease by 31%. In 1936-1937, the Fed raised reserve requirements, causing bank lending to contract. Contrast this with today's unprecedented response.
- There is a profound difference in fiscal policy responses. The reaction in the Great Depression was to raise taxes substantially in 1932, as a balanced Federal budget was considered of paramount importance. Personal exemptions were reduced sharply to increase the number of taxpayers, and rates were sharply increased. We now know that only made a bad situation worse by reducing consumer spending when the economy desperately needed it.

The recent tax rebates are largely credited with holding off a recession until now.

- Our diverse economy is fundamentally different than the agrarian based economy of the 1930's, which suffered several years of poor harvests.
- Unemployment is nowhere near depression levels. Unlike 1929, unemployment insurance benefits keep some cash flow going into the homes of workers who have lost jobs and back into the economy.
- While today's problems are blamed by some on inadequate regulation of financial markets, there was comparatively none in 1929. The SEC, FINRA, or CFTC did not exist yet. Trading on insider information was just considered smart investing.
- If the government's new role in the banking industry makes you nervous, you should read about the NRA and AAA's poorly conceived intrusion into the entire economy.

While 2008 may have few similarities with 1929, looking back we may see a commonality: no one at the time fully understood the breadth or magnitude of the economic problems the country faced. Good solutions were as elusive then as now.

“Our diverse economy is fundamentally different than the agrarian based economy of the 1930's...”



Failed bank, Kansas, 1936

The Panic of 2008 (continued from page 5)

began cashing out as the true nature of the risks in these assets became known.

As the situation worsened in late 2007, another victim came to light – tax exempt bond investors. Bond insurers AMBAC and MBIA had invested in RMBS and faced write-downs. Bond issuers purchase insurance to obtain a AAA rating and lower the issuer's interest cost. Because the bond rating is only as good as the insurer's rating, some \$1.2 trillion of bond debt was subject to being downgraded. As you can imagine, a downgraded bond loses some value, causing even more duress on institutions' balance sheets. Some bonds had to be sold as they fell below a minimum required credit quality, putting further pressure on prices.

By early 2008, a number of firms determined they would need additional capital to stay afloat. Sovereign wealth funds and private equity firms stepped up to the plate and injected billions into a number of firms. One that was not so fortunate was Bear Stearns. In a few short days, other institutions came to believe that Bear was not a good risk (possibly abetted by short sellers) and shut off its funding sources and withdrew capital. In the first

"bailout", the Federal Reserve negotiated an emergency buyout by J.P. Morgan with a \$29 billion taxpayer loan.

Why not just let Bear Stearns fail? The short answer is that Bear was counterparty to a number of interest rate swaps and CDS on the tune of \$3 trillion or more. If Bear had defaulted on such a massive amount of derivatives, other firms would have faced massive write-downs, causing more failures, more write-downs, and no one knows where the cycle would end. It's as though Ben Bernanke and Hank Paulson looked into an abyss and decided the risks of inaction were far greater than the risks of taking action.

As home prices continued to fall and ABS losses mounted this summer, the expanding contagion eventually infected Fannie Mae and Freddie Mac's balance sheets. While neither was a major owner of subprime RMBS, their balance sheets were extremely leveraged (50:1) as they played on their GSE (government sponsored enterprise) status, favor with Congress, and the implied government guarantee of their debt. Here, the government faced a couple of challenges. It was

essential that they stay in business and functioning as normally as possible. Otherwise, mortgage availability contracts, further weakening home prices, causing more defaults, etc. etc. The second big issue was the huge amount of CDS on their debt of \$30 *trillion* – more than twice the GDP of the US. Allowing default was unthinkable. Fannie and Freddie came under government conservatorship and their one-time blue chip shares are now penny stocks.

Next came AIG, the world's largest insurer and a sound company in most of its business lines. There was just this one problem: billions in CDS liabilities. The government made a \$85 billion loan and now owns 79.9% of the company. Fortunately, AIG's annuities and insurance contracts appear to be safe.

Next to go was Lehman Brothers, which was allowed to fail. Although counterparties are impacted, Lehman was judged not "too big to fail". There is now second guessing that it was a mistake to give in to pressure to not "bail out" everyone.

The most painful of all to discuss is Wachovia. Its

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"...Ben Bernanke and Hank Paulson looked into an abyss and decided the risks of inaction were far greater than the risks of taking action."

The Panic of 2008 (continued from page 7)

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balance sheet became weaker and weaker as write-downs mounted from option ARM mortgages and the toxic portfolio it acquired from Golden West. Finally, the FDIC stepped in and brokered a rescue deal with Citicorp that was later trumped by Wells Fargo. There's still much to learn about this deal with thousands of jobs at stake, many of them clients and friends. If there's any consolation, the other local bank came away with Merrill Lynch.

Paulson, et al came to the conclusion that crisis by crisis intervention was not solving the problem and a systemic solution had to be implemented. The next

act to unfold was the TARP – Troubled Asset Relief Program – better known as the \$700 billion bail out. What political theatre while the system continued to choke! The Treasury now has the ability to buy troubled assets from financial institutions to allow them to clean up their balance sheets and presumably resume lending. If things go well, the taxpayers will actually make money when the troubled assets are resold in future years. Paulson also used \$250 billion of the \$700 billion to invest directly in preferred stock of the nine largest banks – whether they wanted it or not – amounting to semi-

nationalization of the banking system.

So where do we go from here? To be where we are now would have been considered an outlandish, preposterous prediction a few years ago. The “wicked system” got us here and, based on experience, we have little chance of predicting where it will take us. These are unusual times.

This article is on a subject that needs a book. Our investment banking clients know it barely scratches the surface. Hopefully, this newsletter helps you to better appreciate the complexity and magnitude of the problems we face.

About Matrix Wealth Advisors, Inc.

Planning is the process of allocating limited resources among unlimited alternatives according to a system of values to achieve life goals.

Founded in 1990, Matrix uses a very personalized, principle-centered process to offer comprehensive financial planning and investment management services that help clients

close the gap between where they are now and where they want to be. Matrix is a fee-only, fiduciary firm and is compensated solely by our clients.



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