

## What Brought Us Here – And Where Are We Going?

### **Q: *What started this financial crisis?***

**A:** Sub-prime mortgages (created by both the lenders & the borrowers) resulted from home loans made under the (incorrect) assumption that home values would continue to rise. Housing prices were driven by speculation, until the bubble burst, and many borrowers were left with negative equity in their homes.

Political persuasions aside, Fannie Mae & Freddie Mac were eventually forced into conservatorship as a result of operational controls dictated by Congress and the Department of Housing and Urban Development (HUD). Congress & HUD forced Fannie & Freddie to offer up to 52% “special affordable” loans, to borrowers with income lower than 60% of their area’s median income. Many subprime borrowers were able to purchase homes with 0 – 10% down, and secure affordable adjustable rate loans, with historically low interest rates at the time.

The Community Reinvestment Act (CRA) forced banks to do the same thing, and by 1995, 80% of bank mortgage loans went to low-income, higher-risk borrowers.

In short, politicians’ *cause célèbre* was to increase home ownership in depressed locales. (Note to Congress: Home ownership may be the American dream – but it’s not an inalienable right. Renting is sometimes appropriate).

From there, many other factors contributed to the mortgage meltdown. These troubled

assets were re-packaged and resold to other financial institutions stamped with an artificial AAA rating since they passed through the government-guaranteed agencies of Fannie Mae and Freddie Mac. When the real estate bubble burst, and market values of homes declined, subprime borrowers began to default on their mortgages, or slipped into negative amortization. Financial institutions that (unwittingly) purchased these “troubled assets,” are required to follow an accounting rule called “mark to market.” This rule requires reporting the depressed market value of their assets (portfolio including subprime mortgages) on their financial statements. Firms that maintained otherwise healthy cash flows were rendered insolvent overnight, based on the accounting writedown. Banks and financial institutions (once considered “too big to fail”) were in violation of regulatory “capital requirements,” making them vulnerable to closure, nationalization, or forced sale.

In short order, banks clung to their cash reserves, too nervous to make loans to individual borrowers or other banks. The LIBOR (London-fixed bank-to-bank lending rate) rose disproportionately higher than the U.S. Federal Funds rate, making it very expensive for U.S. banks to borrow capital. A confidence crisis ensued, and panic-selling in the stock market drove prices down in historical measure over the course of one week, as mutual funds, hedge funds, and individuals dumped stocks --both good ones and bad ones, in effect “throwing the baby out with the bath water.”

**Q: How will the new \$700 billion plan help our economy?**

**A:** Credit markets essentially run on confidence. The broad objective of the plan is to infuse money into the financial system, purchasing impaired assets at prices somewhere between their current dysfunctional market value and their maturity values, holding them to maturity, earning interest in the interim, with the prospect of both the financial institution gaining confidence and recapitalization to start lending again, and the Treasury (the taxpayers) profiting from the transaction.

Other confidence boosting provisions to the plan include: (1) Temporary increase of bank accounts' F.D.I.C. limit to \$250,000 per depositor account category (individual, joint, trust); (2) Increased oversight: the \$700 billion will be released in stages – requiring Presidential certification for drawing additional funds after the Treasury reports on their use of funds and progress in addressing the crisis. Two new oversight committees formed. [The *Financial Stability Board* comprised of the Federal Reserve chairman, the S.E.C. chairman, the Federal Home Finance Agency director, the H.U.D. secretary, and the Treasury secretary – will report to the congressional oversight panel, comprised of 5 members appointed by House and Senate leaders from both parties]. (3) The President is required to submit legislation to cover any taxpayer losses from this plan – by charging a fee to all financial institutions (like an insurance pool). (4) Companies that participate in the “rescue plan” will lose certain tax benefits, and in some cases, must limit executive pay – or payback “golden parachutes” and other bonuses based upon performance targets if it turns out that the financial statements did not accurately reflect the company’s financial position. (4) A side effect of the *Troubled Asset Relief Program* (T.A.R.P.) is a boost to the U.S. dollar.

**Q: How does the current stock market plunge differ from the Great Depression?**

**A:** (1) In the “crash” of 1929, investors were highly leveraged (they borrowed “on margin” up to 75% of the purchase price of their stocks), their brokers were forced to dump their stocks to cover their “margin calls” and interest rates were kept high to discourage additional borrowing; (2) The Dow was down 91%. (3) The Securities & Exchange Commission did not exist in those days to regulate the trades of “legitimate securities”, or to halt trading (putting in a “curb”) to reduce dramatic price movements on a single day; (4) U.S. unemployment rate was 25% during the Depression, while it is about 6% today. Between 1929 and 1932 industrial production declined 52%, corporate profits fell 49%, while 44% of all first mortgages were in default. (5) Investors’ “flight to safety” in cash caused a run on the banks – before the advent of F.D.I.C. insurance on deposits – causing 1,300 banks to close their doors. (6) The U.S. Treasury did not intervene to inject liquidity into the capital markets, since in those days the Treasury had to back up its Treasury Bills with a gold standard. (Today, the Treasury can choose to print money without requirement for gold backing)

**Q: What should I do with my investments now? Am I too old to see my portfolio values restored in my lifetime?**

**A:** A properly managed financial plan already takes into account these risks of periodic sharp market declines, and anticipates these interruptions of the “up escalator” ride of a diversified stock portfolio.

Clients who are receiving periodic cash flow distributions from their portfolios will continue to receive them as in the past; their portfolios have already been constructed to anticipate these temporary market fluctuations.

1. If you receive steady income from employment, guaranteed retirement pensions, or other sources of steady income, you should maintain 6 months – 1 year’s cash reserves to cover your cost of living and other near term expenses. If your cash flow relies entirely on your investments, you should maintain 1-2 years’ cash (or whatever amount lets you sleep at night) so you can avoid selling at the bottom, making panic-driven decisions, and locking in “paper losses” for assured (“realized”) losses in exchange for what you (mistakenly) believe represents “safety.” [Case in point: Last week, investors who fled to the safety of U.S. Treasuries received only 97 cents for every dollar spent!]
2. Aside from default risk, if you hold short-term and mid-term bonds to maturity, you will receive the full face value, and interest payments in the interim. Therefore the value of your bonds listed on your statement reflect current (dysfunctional) market values which are only relevant if you planned to sell them today in midstream.
3. Stocks can restore their fundamental prices as quickly as they decrease. Therefore “capital preservation” means holding your good company stocks – not selling them at the bottom. Panic-selling is not a strategy; it merely moves money from the weak hands to the strong hands.
4. As of Friday’s close, there were over 3,500 companies trading at ridiculously low prices (P/E ratios of less than 8 times last year’s earnings), with 876 companies’ (nearly 1 in 10 companies) stock trading at prices below the per-share value of their cash holdings. Translation: you could buy them for less than the dollar amount of their cash reserves – in effect for “free!”
5. Core holdings such as Coke, Pepsi, Johnson & Johnson, Exxon, Procter & Gamble have experienced substantial earnings & dividend increases every year for 10-15 years, their financial strength ratings are A+ or better, and ranked #1 for safety. Their fundamentals (that which drives the stock price in the long run) are strong; and we expect these companies to use some of their cash reserves to buy back some of their own stock – investors should do the same!

*Credits: Wall Street Journal, CNN Money.com, FDIC.gov, The Market Analysis Research & Education (MARE) group, a unit of Fidelity Management & Research Co. (FMRCo.), Value Line Research, and Professor/Economist Jeremy Siegel, Wharton School of Business, University of Pennsylvania.*

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#### Parting thoughts:

**“Markets are voting machines in the short term and weighing machines in the long-term.”** - Warren Buffett, *Berkshire Hathaway annual Report*

**“The best opportunities are at the point of maximum pessimism.”** – Sir John Templeton

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