LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,610* Dow Jones Industrials 13,322 * 30 year U.S. Treasury Bond 4.78%

Ex Uberance

"Yet some day the tide will go out. Confidence will evaporate, and that will be the end of that." -- ***Insight***, Summer, 2007.

One minute the mortgage industry is turbo-charging the nation's growth with blind undocumented teaser-rate loans to NINJA borrowers (No Income, No Job, no Assets), and financing all the nation's jet-ski purchases by refinancing credit-card debt. The next minute they're sucking all the joy juice out of the economy by refusing to lend money to anybody who needs a loan. *Billionaires only* need apply, and please no jumbo loans . . . .

When times are good, consumers and investors take on more and more risk, adding debt that sets the stage for the next round of economic stress. The really surprising thing about our most recent real estate bubble is that millions of investors had *personal experience* with a similar event in the 1980s. Wall Street had just invented mortgage-backed securities, allowing banks to sell your home mortgage instead of holding it. A tidal wave of new money flowed from investors to home owners, and a generation of Wall Street traders got rich—as chronicled by Bonfire of the Vanities, Liar's Poker, and other tales of avarice and sudden wealth.

Then came the real estate bust, driving down home prices on the east and west coasts, and sending the Masters of the Universe into retirement. Here in the Northeast home prices didn't fully recover until 1996, *eight years* after the bubble burst. Wall Street's big brokerage firms fell on hard times, challenged by diminished investment banking opportunities and new competition from a slew of discount brokers.

They called the 80s the Decade of Greed, but by the turn of the millennium the 80s looked like a time of austerity and thrift. The greatest stock-market bubble in history was driven by journalists and individual investors, endlessly repeating mantras that were *made* true by endless repetition. And when that bubble of little white lies burst, the same journalists and investors set to work creating a bubble in the real estate market; again bending reality with endless repetition of theories that had had been soundly disproved a mere decade before.

Just as in the Eighties, the new landrush was fed by innovations in the way mortgages were sold on Wall Street; innovations which stuffed more and more investor cash into the pockets of homeowners. And into the pockets of Wall Street. For many investment bankers the gigantic bonuses paid last January were a reward for creating the mortgage panic of 2007 . . . . . Let us hasten to add that the bankers had plenty of help, starting with the homeowners, appraisers, and mortgage brokers who were colluding to falsify loan documents.

Wall Street sucked in huge numbers of these bad mortgages, bundled them into pools, and convinced the supine rating

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Why Investors Stick With the Herd

"Lemmings may have a rotten image, but no individual lemming has ever received bad press."

-- Warren Buffett

Ex Uberance *continued from page 1*

agencies that the pools were safe because they were *diversified* pools of bad mortgages. The new wrinkle was that you could buy safe and risky securities from the same pool, by designating some of the investors, in advance, as the fall guys who would accept all the pain of homeowner defaults.

Other investors were shielded from losses under any conceivable circumstance, and that allowed Wall Street to sell lowly mortgage-backed securities *(and pools of junk bonds!)* to college endowments, pension plans, and other risk-averse investors who had never bought them before. Of course, you can't favor some of the investors in a pool without disfavoring others, so the key to marketing these innovative new securities was to find investors foolish enough to buy the insanely risky parts of each pool. The bankers themselves openly referred to these risky bits as "toxic waste".

An army of crackerjack Ivy-League MBAs can solve any problem, and it didn't take long for them to realize that they could broaden their toxic-waste clientele beyond crack addicts and morons by selling to people who didn't speak English. In recent weeks world markets have been rattled by sub-prime mortgage revelations from major Asian and European banks . . .

Still, the most interesting solution involved the new lords of the money-management business, the managers of hedge funds. Why would hedge fund managers be willing to take senseless risks? Because they could become personally wealthy, in a very short time, by doing so. They pocket 20% of any income or growth that their funds produce, and the "promised" rate of return on these securities was huge. Better still, they could triple or quadruple the returns by borrowing large amounts of money, and the fact that the loans came from their Wall Street toxic-waste dealers was seen by both sides as a guarantee that the shakiest parts of the mortgage junk and bond markets would stay afloat for a while.

Let's say you're running a billion-dollar hedge fund, and you can get an 18% return by investing in toxic waste. Your portfolio will produce $180 million a year. And your investment banker guarantees that he's going to keep the party going by offering you (and all your hedge-fund-manager friends) giant loans at an interest rate of just 5%.

You dive in with enthusiasm, borrowing $4 billion and investing it all—along with your original billion—in toxic waste. In the first year your hedge fund hauls in $900 million (an 18% return on $5 billion), and pays $200 million on the loan. That leaves $700 million in profits, and your 20% cut is $140 million!! Taxed at a special 15% rate!!

Who cares if the fund blows up next year??? You're set for life.

3 hedge fund managers and one greedy little pig.

BUY TREASURIES

When interest rates are declining in a weak economy, you can't find a better haven than long-term U.S. Treasury bonds. Bond prices rise when interest rates decline. The longer the maturity the greater the profit you will realize. We believe that, over the course of the next two years, long-term treasuries will give you income of 5% per year along with a 20% capital gain.

SELL JUNK

The prices of high-yield bonds have declined, but not much—and there is still great risk for investors here.

If you own a bond fund with a "dependable" 8% yield, there's a very good chance that the price of the fund will decline until the yield reaches 10%—and decline further if some of the bonds in the fund default. Twenty-five and thirty percent losses might prove to be the norm . . . .

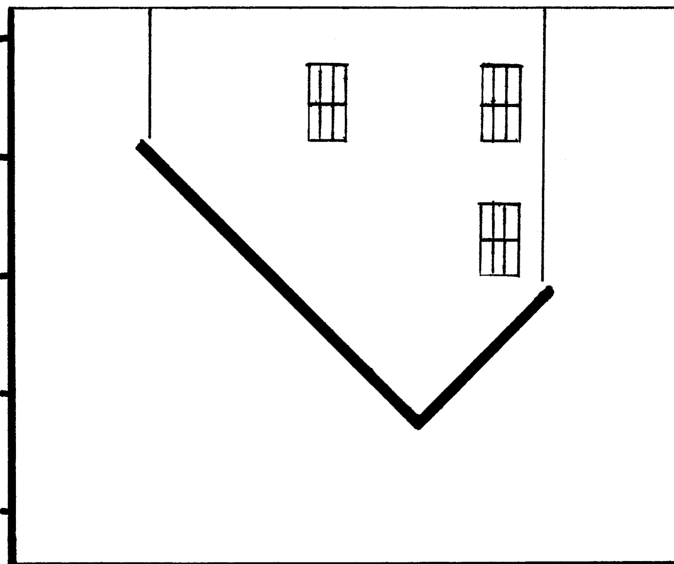
EASY STREET

To hear some pundits talk, you'd think that we're all working harder but getting poorer. The truth is that American living standards have been improving for decades, at every level of income.

Stephen Rose, an economist who worked for the Labor Department during the Clinton administration, recently published an exhaustive study of incomes that adjusted for the growth of our retired population, the increase of single-parent families, and other factors. He says that from 1979 to 2004, the ranks of the conventionally-defined poor shrank from 9.8% of the population to 9.3%—despite a huge influx of illegal immigrants that sharply depressed their wages. The ranks of the "near poor" shrank from 14.2% of the population to 13.7%.

The middle class is indeed shrinking! It shriveled from 47% of the population to 39.2%. However, the reason was that a huge number of households jumped into the "well off" category. The rich, defined as households with incomes above $90,000, have increased from 29% of the population to 37.8%.

If you think back to the late 70s, or even the decade-of-greed 80s, it seems obvious that we've all become wealthier. Back then everybody lived in "small" houses, drove gas-sipping cars, and saved their earnings for retirement. Government spending—at all levels—was lower. We're all living like the Great Gatsby, and the least we can do is admit to our good fortune.



UPSIDE DOWN

The graph above shows that—after a decade of rising mortgage debt and two years of falling home prices—millions of home mortgages are now "upside down", or larger than the values of the homes that back them. Our sources say that 12% of the nation's mortgages are upside down, and that the number is growing . . . . .

Blame can be laid at the feet of mortgage investors and investment bankers, who clamored for more and more mortgages written at 80% of value, 90% of value, and finally 100% of value. *How stupid is that?* Blame can also be laid at the feet of the rating agencies who catered to the investment bankers instead of serving the needs of investors. Then again, the rating agencies are paid by investment bankers, not investors; why would anybody expect them to behave differently?

BRISTOL-MYERS

"We believe that the patent on Plavix [attacked by a Canadian generic-drug company] will eventually be upheld. It *was* upheld—note the irony—in the *Canadian* courts, and it's an important matter for the U.S. courts because there are scores of drugs whose intellectual-property protection will vanish if this "single isomer" patent is overturned . . . . . Buy Bristol-Myers below $22."

-- Insight, Autumn 2006

The Chinese, upset by US accusations of currency manipulation, have been threatening to sell a trillion dollars' worth of US Treasury bonds that they purchased in the last decade. The funny thing is that they purchased the bonds to manipulate the currency markets . . . . . and if they sell them the dollar will indeed decline. As requested.

Furthermore, they'd take a stupendous loss on their investment. Next month, the plan is to threaten to have a billion Chinese hold their breath until they turn blue . . . .

John Lumbard, CFA

Our clients are pleased with the growth of their investment portfolios, and they're even more pleased about the things that we do not do. We're not aggressive investors, eager to take big risks with "other-people's money"; or trying to harvest the kind of giant incentive-based fees that hedge funds collect in good years. Unlike Fidelity and other hard-nosed firms we don't charge termination fees, and we don't have any hidden "soft dollar" kickback arrangements with stockbrokers. We're in this for the long term, patiently building wealth for our clients.

For many years we've been giving you occasional updates on the growth of an account that one of our wonderful clients established in 1990—and has kept segregated and untouched just so that we'd be able to track it. The portfolio has always been invested just like our other "balanced" accounts. We don't show it any favoritism in trading, and it performs no better than its peers. It pays fees at a 1% rate, and it has always been invested in a conservative-yet-global mix of bonds, cash, and stocks. On August 31 the account's value stood at $ ***451,894***, up from $100,000 in October of 1990.

Further information regarding performance, fees, and our account minimum can be found at *www.lumbard.com*.

THE SCHOOL OF HARD KNOCKS

Have investors learned that it's a bad thing to follow the herd? Of course not! The lesson of the last two decades is that the key to investment success is to be one of the first to identify the *next* bubble in stocks, bonds, commodities, currencies, or real estate.

And will this be the lesson that investors learn from the markets of the next five years? Not likely . . . .

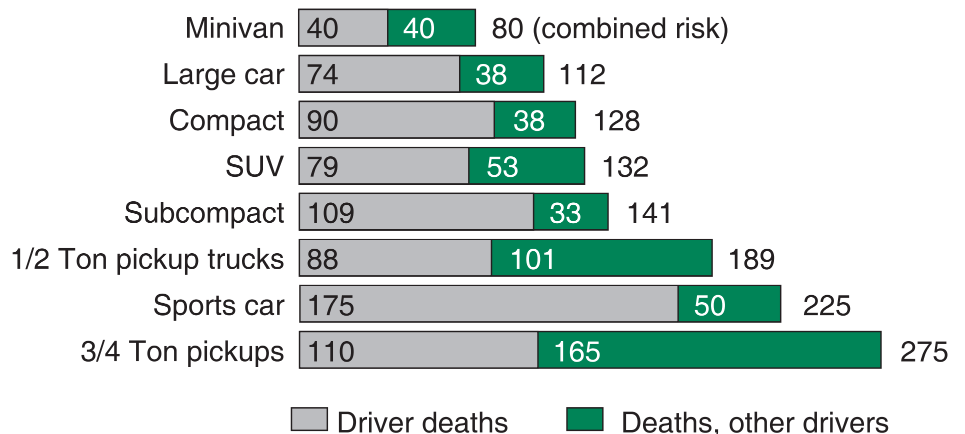
"On average, the stocks of companies run by leaders who buy or build mega-mansions sharply underperform the market."

-- The Wall Street Journal, citing a study by NYU professor David Yermack

FATALITY RISK BY VEHICLE TYPE

"The risk-to-others increases sharply with pickup [truck] size . . . . Of all light-duty vehicles, the One-Ton pickups are the most dangerous to others on the road . . . . . . The average One-Ton pickup kills about 10 times more people in other vehicles than an average Camry . . . . . during its life an average One-Ton pickup has a nearly 1% expectation of killing someone in a traffic crash."

-- Marc Ross, U. Michigan, and Thomas Wenzel, Lawrence Berkeley National Labs



Source: Wenzel and Ross / *Los Angeles Times*

PREDATORY LENDING

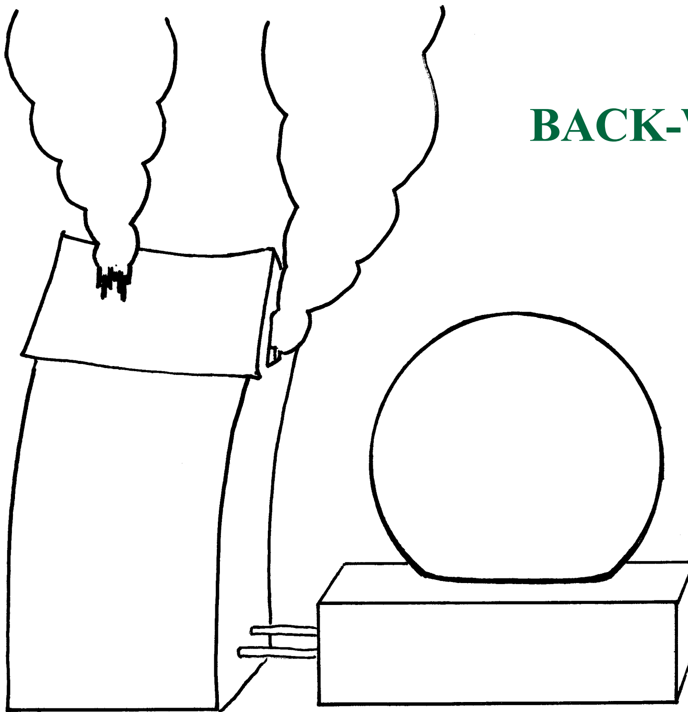
30 years ago, when interest rates were higher than they are today, we had usury laws that limited the rate of interest on a loan. Even a loan from a leg-breaking loan shark was supposed to be limited to 21%. Today banks are routinely charging rates of 32% or more—plus a $35 late fee—to inattentive credit-card customers who miss monthly payments. They're preying on the elderly, the poor, and those who can't get to their mail in the 10-day window they give you for paying the monthly bill.

The banks have also ratcheted up fees on wire transfers, ATM usage, and everything else. It's always about money, but for Bank of America this policy of shamelessly overcharging customers makes even more sense. They have a *need* to push customers out the door, because they've acquired so many banks that they've grown past the legal limit of 10% of the nation's depositors.

The problem isn't limited to Bank of America, and it goes way beyond credit cards. In the good old days a "bank check" was considered to be as good as cash, but nowadays that's only true if you take it to the issuing institution. Most of the nation's large banks will continue to freeze the deposit of a large bank check for days *after* the banks have transferred the assets. With amounts exceeding $5,000 they're allowed to hold the funds for "a reasonable time frame".

Drew D. Kellner

There's nothing "reasonable" about a multi-day period in which your bank freezes your deposit so that it can earn interest on *your* money. Ask your bank about its policies, and give your small local banker a chance.



BACK-WOODS NUCLEAR POWER

The Vermont Yankee nuclear power plant has run safely (and CO_2 free) for 35 years. But in August it was forced to power down to 50% of capacity because of structural problems in a cooling tower. During the winter months the plant is cooled by water from the Connecticut River, but it would be harmful to aquatic life to warm the river in the summertime; so they spray scalding-hot water "like rain" into cooling towers that were built in 1972.

The problem is that the cooling towers are made of *wood*. "I don't know if I'd characterize it as rotting," said a Nuclear Regulatory Commission spokesman; [it's more like] "sagging, deformation in some of the wood."

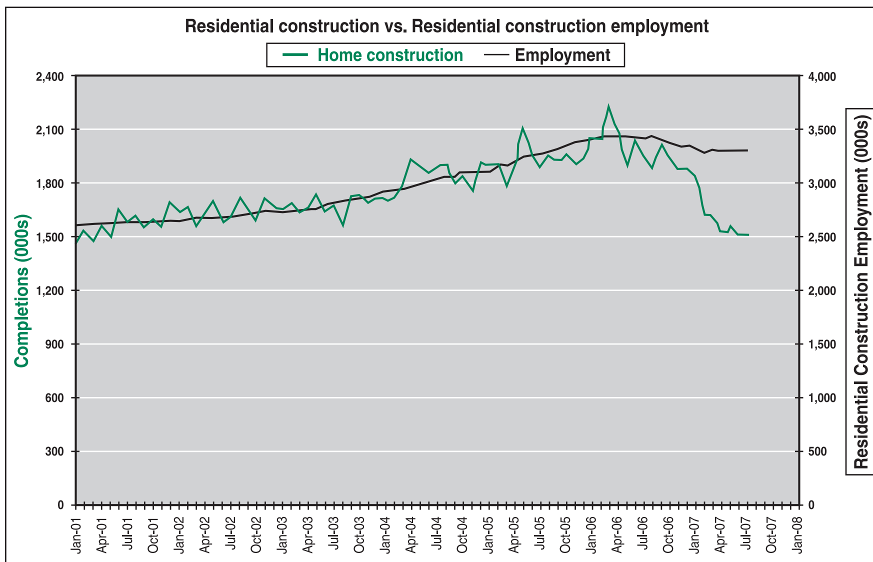
CREDIT CRUNCH

Cars, boats, swimming pools, refrigerators, and granite counter tops. These are the kinds of things that consumers finance with home-equity lines of credit and cash-out refis. Mortgage debt is also used to pay off credit card balances, and in this way homes have become the collateral that allows purchases of groceries, jet skis, and skidoos.

For millions of Americans, these loans are no longer available. Everybody knows that the mortgage crisis has accelerated the downward slide of home prices, and helped to shrink the nation's home-building rate from 2.1 million to 1.4 million a year. But the end of the freewheeling, anything-goes mortgage era has also affected the purchase of carpets, light fixtures, bedroom sets, and bicycles. And all this is playing out at a time when the effect of the Fed's most recent interest-rate increases (in mid 2006) are only just beginning to be felt by the economy:

"Tighter monetary policy starts to have some effect on GDP right away, but it is very small. Then the effect builds, with the peak effect occurring between eight and 12 quarters out. . . ."

--- Alan Blinder, former Vice Chairman of the Fed's Board of Governors.



In our last issue we noted the odd disparity between sharply-declining home construction and steady employment in the construction trades. The graph above offers a visual representation that's more compelling than mere statistics. Employment for the years prior to 2006 was probably undercounted, dramatically, because of the widespread employment of illegal immigrants in the construction trades. When layoffs hit they melted away without a trace. And the most recent period is probably distorted by a fudge factor that the Labor Department uses to account for jobs at new businesses that they've never heard from.

HONESTY IS THE BEST POLICY

The proposed "cap and trade" limits on carbon dioxide emissions are a regulatory nightmare, in which the winners are the businessmen who figure out how to game the system. It's all about bribing the regulators to get more carbon-dioxide credits, deceiving the testing labs that measure CO_2 output, or bribing their employees.

It's foolish to think that a program of ever-tightening credit allocations is going to somehow motivate an electric utility to increase the efficiency of a General Electric turbine that's the product of decades of experience and engineering. The most-likely way to get that improvement is to *increase* CO_2 output in the baseline year, so that you can create the illusion of improvement . . . .

Any cap and trade system is going to foster corruption, create inefficiencies and bottlenecks, and increase costs. If you're trying to motivate businessmen and consumers by raising the cost of CO_2 emissions, why not just hit them with an honest and straightforward tax?

John Lumbard, CFA

Performance Results:

The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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