

LUMBARDE
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 1,984 * Dow Jones Industrials 10,365 * 30 year U.S. Treasury Bond 4.16%

THE GREAT MORTGAGE MESS OF 2008

“Just as in the [real estate boom of the] Eighties, the new land rush 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 [2007] 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.”

[Insight](#), Autumn 2007

We wrote these words last fall with the clear expectation that a financial crisis would unfold in dramatic fashion during the final months of 2007. By then the mortgage mess was already old news; we also covered it in the lead story for our Spring 2006 issue (see “The Bubble Bath” in the back issues posted at www.Lumbard.com). The real surprises have been that the economy was able to hum along so merrily for most of a

year, and that so many financial institutions are still holding the bag more than two years after they’d been told that millions of homeowners were going to default on their mortgages.

Now the U.S. government is going to buy troubled mortgage securities in a program patterned after the Resolution Trust Company. The RTC cleaned up *hundreds* of failed Savings and Loans institutions after the real-estate bubble of the 1980s. The nickname for the new company is RTC II. They’re calling it an *unprecedented* bailout.

This is the first unprecedented sequel in history.

When you look at any big problem in hindsight, it always seems very simple (Why did the tech stocks crash in 2000? Because they were too high). That sort of clarity will come to the mortgage mess in just a few months. Millions of homeowners are defaulting on their mortgages, so banks and other investors are fleeing in a panic from mortgages—and from any other newfangled securities

that are related to mortgages in any way. Mortgages are suddenly almost worthless, and nobody wants to do business with banks that hold great piles of them.

That’s a big problem, because bank lending is essential to economic growth. As we go to press it seems likely that the federal government will buy a big chunk of the nation’s home mortgages in an effort to bring prices up to a reasonable level. While the taxpayers are shelling out hundreds of billions (at 100 cents on the dollar) to buy bad mortgages from Fannie Mae and Freddie Mac, they’re going to purchase Wall Street mortgages at a big discount.

How big will that discount be? That’s the question of the day. A deep discount would probably result in the failure

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“Buy at the point of maximum pessimism.”

Sir John Templeton

1912-2008

The greatest investor.

MORTGAGE MESS

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of quite a few more banks, while a small discount would bail them out. There's no question that the rescue of Fannie and Freddie deserves to be called a bailout, but we won't know about the use of that word for the Wall Street mess until we see what the Treasury actually does. The agreement with Congress is much less important than you might think, because—as is so often the case—the devil will be in the details.

What is needed is an initiative that stabilizes the markets—bringing the prices of mortgage securities up to a level that allows healthy banks to function—without bailing out troubled banks. For decades the United States has been telling other countries that they shouldn't bail out their banks, so it would be hypocritical (not to mention very expensive) if we did it ourselves. Japan bailed out its banks after a similar real-estate bust in 1989, and the result was a recession that lasted for 12 years.

Will the stock market plunge further? There was a good deal of fear-driven selling in the stock market in September. Fear flushes most of the likely sellers out of the markets, and sharpens the minds of buyers. We're feeling much better about the prospects for stocks in the year ahead.

Our biggest concern is the wild optimism of Wall Street's analysts. At last report the analysts who follow the Information Technology industries were still thinking that their companies would see 17% earnings growth in 2009, after a robust performance in the final three months of 2008!! Bearish readers might like to know that the Rydex Arktos Fund bets on a further decline in the big technology stocks

So when will the market reach the precise bottom? The lowest of the lows? We doubt that we'll see the S&P 500 break 1,000, and if that's true we're almost there. This is not a matter of investment judgment but a short-term trading decision. Don't get left behind.

That's because those half-dead banks were on life support, unable to make loans. They were actually sucking up resources that would have otherwise flowed to healthy banks and growing parts of the economy. Japan's government interfered in other ways with legitimate businesses and free markets—they built bridges to nowhere!—and the nation's debt grew larger as the economy stagnated. We can't put our own banks on life support, and—similarly—we can't allow any new earmarks or entitlements.

now we're learning that the goal of extending home ownership to millions had a very stiff price.

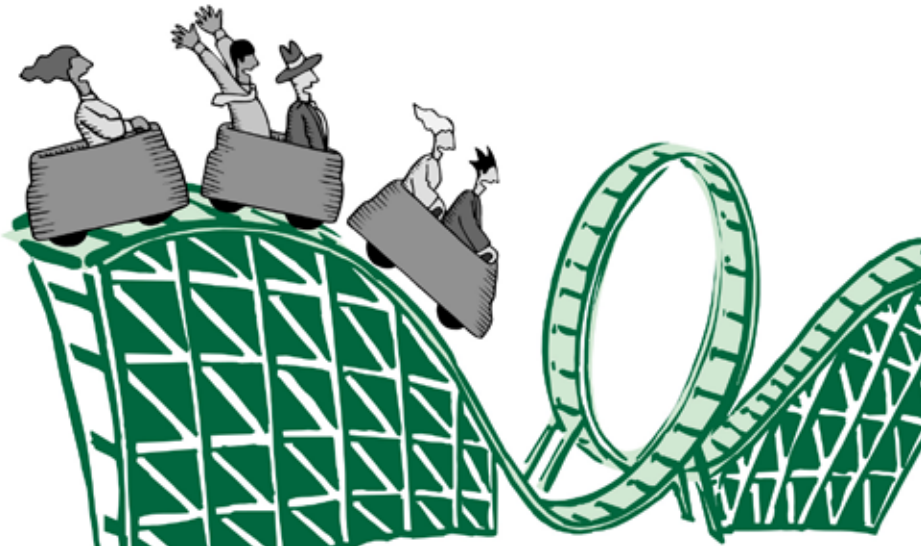
While we're at it, we also might insist that mortgage brokers "put some skin in the game" by actually investing in some of the mortgages they write. It's amazing how a little ownership can bring out the best in people Beyond that, there's no evidence that we need additional regulation. We had state mortgage regulators, state insurance regulators, SEC regulators, and federal banking regulators crawling all over the companies with the biggest problems. They looked right past the liar loans, the NINJA loans (No Income, No Job or Assets), the unreasonable leverage, the obvious real-estate mania, and the securities that investors were eagerly snapping up in full knowledge that the stuff was *called* toxic waste.

What can we do to prevent a mortgage meltdown in the future? The simplest solution would be a return to the old-fashioned insistence that a homeowner own at least 20% of the value of his home (crazy idea, huh?). For years the Congress, Fannie and Freddie, and Wall Street have been pushing for easier lending standards, and

GOOD NEWS!

“ . . . during recessions people drink and smoke less, get sick less, and even die less than during boom times.”

The Boston Globe. Research by Christopher Ruhm of the U. of North Carolina



If all goes well the Treasury will fix the crisis of confidence in the markets in just a few weeks, at a cost that is ultimately less than the cost of bailing out Fannie and Freddie. That's not really the end of the story, because thousands of homeowners are still walking away from their home mortgages—with no sense of responsibility whatsoever—every week. These are real losses that will be borne by somebody, and the defaults will put additional homes on an already-overburdened real-estate market.

It seems like a downward spiral, but it would be a mistake to try

to stabilize home prices. Putting real estate on life support would be no better than putting banks and brokerage firms on life support. If real estate prices stagnate or decline slowly for years, no one will want to buy homes and there will be no recovery. The best answer is to allow prices to fall rapidly to a bottom—a place where buyers can't resist the bargains—from which prices can begin to rise and confidence can be restored.

Our population is still growing, so eventually we'll need to build more houses. Appliances, carpets, and automobiles all need to be replaced

from time to time, and right now millions of drivers are waiting for a chance to trade in the dinosaurs they've been driving to buy cars that get 30 miles to the gallon.

Interest rates will decline because they *have* to decline. It doesn't take a rocket scientist to realize that the Federal Reserve will want to bring down mortgage rates, and you'll see them take aim at the rates on adjustable-rate mortgages in the very near future. In the months ahead they'll aim their guns (money cannons, actually) at the yield on the 10-year U.S. Treasury bond, which serves as the benchmark for figuring the yield on 30-year home mortgages.

Lower interest rates on corporate loans will help businessmen in the same way, and they will eventually begin to invest in new factories, new technology, and new businesses. Every few years the economy is derailed by excessive debt or other issues, but it *wants* to grow. Eventually, it will.



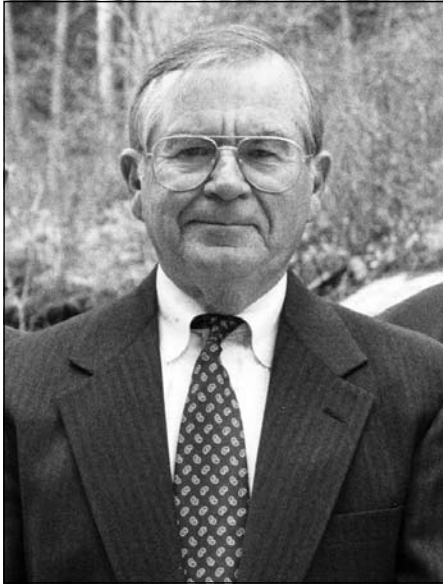
MORE GOOD NEWS

Good News? You want good news? Well, inflation is not the problem that all the pundits thought it would be. The simple truth is that in the long run commodities always sit at a price that's barely above the cost of additional production, and they're nowhere near that level yet. Consumers and corporations will reap the benefit as prices fall.

Meanwhile stock prices are finally getting down to levels that reflect the weak-economy, declining-earnings, and falling-interest-rate environment that the real world has been in for almost a year. With the broad market down 30%, it's going to be a lot easier to get a good return in the next five years.

The air started to go out of the real-estate bubble two years ago, and we've made twelve months of progress in unwinding the mortgage mess. Inflation is not careening out of control, gas prices are falling, and plumbers have started making house calls again.





John Convery Jr., CFA

In recent months investors have been worried about the prospects for the economy, the stock market, and individual stocks. It's a time when we all need to be reminded that investing is a long-term discipline that requires patience and a willingness to look past the problems of the short term.

Boeing (BA - \$55) is a case in point. The company is in the middle of a crippling strike, but there is every reason to believe that



its earnings will increase dramatically a year from now, when deliveries of the 787 Dreamliner begin.

The 787 is the first large carbon-fiber airplane, and its fuel savings will offer a significant competitive advantage for the airlines that put it into service. The company has 892 orders worth approximately \$140 billion, from 57 customers around the world. Those orders will last for many years even if the difficulties of the airline industry lead to cancellations, because Boeing plans to deliver about 120 planes a year.

Keep in mind that Boeing's earnings have been artificially depressed by costs related to the 787. A year from now that R&D burden will be lifted.

Investing is always filled with uncertainty, but order backlogs for the 787, the defense business, and other aircraft—even older programs such as the 737—will insulate Boeing's earnings from the weakness in the U.S. economy. Investors receive a 2.9% dividend while they wait for management to reach an agreement with its unions. And you can be sure that, eventually, the strike will come to an end.

The \$700 billion that the Treasury has asked for seems like a lot of money, but it's a one-time expense—as distinct from an outlay that has to be made every year. The latter would be about **20 times** as large.

According to the Congressional Budget Office the Medicare program alone will soon—seven years from now—cost \$726 billion *each and every year*; and it will be growing like topsy. By then the Treasury will have recovered a good part of its initial outlays for mortgages. The ultimate cost will probably be less than that of the Fannie/Freddie bailout.

When the news is full of stories about bank failures, rising unemployment, and personal bankruptcies, keep one thing in mind. Never in history have we been more capable of feeding and housing all our citizens. 70 years ago Americans dreamed about having “a chicken in every pot”, but today it is nearly a realized fact. And that won't change, regardless of how bad the consumer-confidence numbers become, or how bad the stock market looks.

GRIDLOCK IS BEST

“ . . . markets tend to get nervous when Congress is in session, and generally perform better when it isn't. As economists Michael Ferguson and H. Douglas Witte have shown, the impact this tendency can have is dramatic. Analyzing stock returns since the Dow Jones Industrial Average was created in 1897, they found that an astonishing 90 percent of its gains occurred when lawmakers were on vacation.”

-- Jeff Jacoby, The Boston Globe



John Lumbard, CFA

The yields on money-market funds, CDs, and other short term instruments will drop below 1% in the next few months. Even a tiny return looks good at a time when the stock market is falling, but it's rare to see an investor flee to cash and then return in time to catch the dramatic rebound.

If you have a big loss in a stock, forget about your purchase price. The important question is whether the stock will rise from here; not over the course of a few weeks, but over the course of two years. Most investors will sell immediately if they decide that a stock which declined from \$40 to \$20 has no chance of returning to \$40. Yet a rebound to \$28 would be a huge gain—a 40% gain—from today's depressed \$20 price.

A stock which falls 50% from \$40 to \$20 will gain **100%** if it rises back to \$40. And stocks never wait for a visible upturn in the economy, but instead surprise investors with breathtaking rallies that leap out of the midst of despair.

SAFETY

The meltdown in the real-estate market has crippled financial companies around the world. The oil and commodities bubbles are bursting. The stock market is down almost 30% in the last 12 months.

In the midst of this misery our accounts have been holding up reasonably well. Our huge holdings of U.S. Treasuries have been a tower of strength, and we have a few other holdings—"short" funds, and a very few stocks—that have moved higher. Our benchmark account—the one that started at a value of \$100,000 in October of 1990—stands at \$432,429, down from \$461,826 at the beginning of the year. We've dodged a lot of bullets this year, and now we're adding stocks at today's low prices.

Congress has been pushing for looser and more-risky mortgage-lending standards for decades, meddling aggressively and dangerously with Fannie Mae and Freddie Mac even after the scale of the mortgage crisis became apparent more than two years ago.

Government meddling played a key role in the Great Depression, which started with the bursting of a stock-market bubble but accelerated downward under the weight of the Smoot-Hawley tariffs on imported goods. Those tariffs were meant to protect blue-collar Americans, but instead they put people out of work. Hoover's next bright idea was to redistribute wealth with a tax increase, raising the top marginal rate from 25% to 63% . . .



Drew D. Kellner

THE LONG AND WINDING ROAD

Congratulations to Drew Kellner, who received word in August that he had passed the examination for CFA Level II.

33,449 applicants, worldwide—from Edinburgh, Stockholm, and Zurich, and also from cities such as Kathmandu, Windhoek, and Vilnius—sat for the exam. 46% passed. The pass rate in Drew's Level I exam was just 34% They say that the third and final exam is a little bit easier

SEE NO EVIL, SPEAK NO EVIL

Fannie and Freddie should have been the first to sound the alarm about ever-loosening standards in mortgage lending Instead they packaged up those liar loans and sold them to millions of investors.

PIPELINE OF PLENTY

We're on the threshold of another natural gas boom in America. It's a lot easier to build a gas-fired electric plant than to build just about anything else, and the nation is trying to get "off oil" and "off coal" at the very same time. Gas-fired power plants don't spew mercury or particulate matter into the air, and they produce little more than half the carbon dioxide that coal plants produce.

Our additional demand for gas will be met with new supplies, because the high oil and gas prices of recent years spawned a technological breakthrough. Free markets really do work Suddenly it's become possible to extract gas from the "tight" shale deposits of Texas, Louisiana, the Appalachians, and elsewhere---a total of 22 shale deposits in North America alone. These shales hold enough gas to meet our needs for decades, and it's more than likely that they'll cause natural gas (and liquid fuels derived from gas) to win market share from oil. Boone Pickens wants to put compressed natural gas in your car. Soon.

The new technology involves drilling a mile underground to get to a bed of shale, and then twisting the drill bit at an angle until it—and the pipe pushing along behind—have made a 90-degree turn. It's no small feat to do this accurately, but today's drillers are routinely able to hit precise targets far underground,

drilling in any direction that will intersect the maximum number of fractures in a bed of shale. Then they force water into the shale at high pressure, fracturing the walls with the same "hydro-fracking" technique used to improve the flow of a water well here in New Hampshire.

In the case of the Barnett Shale of northern Texas, these feats are accomplished in the middle of suburbia. Talk about pressure . . . The driller gets a higher price for the resulting gas, because it doesn't have to go far to reach consumers. The same is true of the nearby Haynesville and Fayetteville Shales in Texas and Louisiana, where some wells have been producing a million cubic feet of gas a day.

We're even more excited about the Marcellus Shale of the Appalachian region, which lies just 100 miles from New York City. Cleveland and Pittsburgh sit on top of the Marcellus; Philadelphia, Baltimore, and Washington DC are close by. This isn't just one of the most-densely-populated regions of the country; it's also a region that is extremely hostile to the construction of new coal plants, wind turbines, nuclear plants, and just about any other form of generation other than natural gas.

Pipelines already crisscross the region, and we think that they offer some of the best investment

opportunities in the energy industry. Drilling companies only make good money in these new shales when the price of gas is above \$8 per MMBtu, and it has fallen through that level already. It's far better to bet on increased consumption, which will bring benefit to pipelines, gas turbine manufacturers, natural-gas-powered city buses, and who-knows-what else.

General Electric is the big dog in gas turbines, but every time we look at it we wish that it were not also a financial and media conglomerate. It's easier to love Spectra Energy (SE - \$24) and NiSource (NI - \$14), two giant pipeline companies that connect the Barnett, Haynesville, and Marcellus shales with most of the population centers of the East. NiSource is a bottom-fisher's delight; the stock is at its 5-year low, and pays a towering (and safe!) 6.5% dividend.

Last but not least is Pepco (POM - \$23). The company owns natural-gas-fired electric generating plants that sell their power into an unregulated market—the PJM Interconnection—in the states above and around the Marcellus Shale. Rising power demand and a not-in-my-backyard attitude towards power plant construction will conspire to push up the price of electricity in this region even as the cost of gas declines.

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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