

Market Outlook

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Waterloo

Europe of the early 19th century was dominated by one man-Napoleon Bonaparte. Born in Corsica to a family of minor nobles, as a young soldier he found himself in the middle of the revolutionary fervor sweeping across Europe in the wake of the 1789 French Revolution.

Although a child of the Enlightenment, he nevertheless attempted to create an aristocracy when he crowned himself emperor in 1802, a long French tradition that had been eliminated by the Revolution. Not satisfied with being merely the ruler of France, he fought and conquered his way eastward, only to suffer a massive defeat in Russia in 1812. His ambitions to rule over Europe are still recognized today as the epitome of arrogance, conceit, and a sense of one's own invincibility.

After Napoleon's domination of Europe from 1800 to 1812, the rulers of Europe wanted to ensure that no one would ever be able to come so close to taking over all of Europe again. To this end, the diplomats from all of the Great Powers met at the Congress of Vienna. There they reorganized European boundaries in hopes of creating a stable Europe where coalitions of nations could always ally to defeat one nation that got out of hand.

However, Napoleon engineered an amazing rise to power, escaping from island exile on Elba for one last reign known as the "Hundred Days." Declared an outlaw by the Congress of Vienna, Napoleon did what he always did when he was in trouble: he went on the offensive. With his newly raised army, he attacked the Belgian town of Waterloo. There, at the hands of the Duke of

Wellington, he met his final defeat. The word Waterloo has forever after been associated with the ultimate defeat; the stupendous fall from grace that comes only after being convinced of one's own infallibility.

The current bear market in stocks represents more than just mortgage foreclosures, the decline of earnings, or worries about consumer spending. It represents the

Waterloo of "financial engineering" on Wall Street. History will lay the blame for the mortgage debacle and the vaporization of shareholder equity in many of the largest and best known financial companies in the world at the feet of the big-brained Ph.D.s, quantitative hedge funds, and derivatives factories that have increasingly gained favor on Wall Street. Like Napoleon in 1814, financial engineering's fall from grace is shocking, highly disruptive and likely to change the investment landscape for years to come.

Financial engineering is defined as the creation of new and "improved" financial products through innovative design or repackaging of existing financial

instruments. Financial engineers use various mathematical tools in order to create new investment strategies. Done well, the new products created by financial engineers can serve as solutions to problems or as ways to maximize returns from potential investment opportunities. Credit card receivables, car loans, and of course, home mortgages are all examples of loans that have been engineered over the years into "securitized" products that have been ~~inflicted~~ offered to the general public. Many people own bond mutual funds that invest in mortgage-backed securities in their personal or retirement accounts.



Former emperor, dictator, and hedge fund manager

Mortgage-backed securities have existed since the 1980s, and the basic structure of these securities have stood the test of time. Where the financial engineers got it wrong is by overreaching. By engaging in statistical self-delusion, they came to believe in the infallibility of their mathematics. In true Napoleonic fashion, they plumbed the depths for less and less creditworthy borrowers in the belief that only a statistically insignificant number of defaults would occur. Their army of analysts would, they thought, quickly discover problems, and nip them in the bud. Moreover, their analysis "proved" that an *en masse* default scenario and collapse was so implausible that it could occur only once every 500 years. Unfortunately, nobody told them that 2007 was the year.

In 1815, Napoleon was exiled to St. Helena, a speck of

rock in the south Atlantic. Similarly, we believe financial engineering will be exiled to remote corners of the investment world. While mainstream products such as mortgage-backed bonds and zero-coupon bonds will maintain their stature, the exotic, bewildering, and risky derivatives that are creating havoc in the

banking and brokerage industry will become mere footnotes in financial history. Today's generation of investors will never forget the reckless piling on of debt and disregard for clear and obvious risk that financial engineering encouraged, only to bring the very credit markets that serve as capitalism's life blood to a weary crawl.

Greater Regulation Ahead

We believe a new era of investment regulation is dawning as a result of the fall of financial engineering. Ironically, for an industry dominated by free market ideology and Republican politics, Wall Street has brought increased regulation upon themselves.

Over the past decade, numerous financial regulations have been weakened or completely abolished, aided by artful lobbying by the banking industry. Probably the

most significant was the repeal of the Glass-Steagall Act, a depression-era regulation that forbade banks from underwriting securities or owning brokerage houses. One of the effects of the repeal was to allow commercial and investment banks to consolidate.

Numerous economists and analysts have criticized the repeal of the Glass-Steagall Act as contributing to the 2007 subprime mortgage financial crisis. Losses at financial firms from the mortgage collapse may eventually amount to \$600 billion as defaults on home loans grow, says Zurich-based UBS AG. One reason banks are losing money is the repeal nine years ago of the 1933 Glass-Steagall Act, which separated commercial and investment banking after excessive risk-taking

contributed to the Great Depression.

The repeal enabled commercial lenders such as Citigroup, the largest U.S. bank by assets, to underwrite and trade instruments such as mortgage-backed securities and collateralized debt obligations and establish so-called structured investment vehicles, or SIVs, that bought those securities.

The result is stunning. Citigroup, which has fallen 65% since early 2007, reported its

biggest loss in its 196-year history. It may have writedowns of \$15 billion this quarter, according to Merrill Lynch, in addition to the \$22 billion that Citigroup already lost because of the housing slump.

"Glass-Steagall protected bankers against themselves," said Jean-Marie Eveillard, a respected mutual fund manager. "Bankers are sheep. They don't mind going over the cliff if everyone else goes over the cliff." The sheep are going to be corralled as the backlash against them grows.

Epitaph

Few will cry over the passing of the era of financial engineering. Though a few profited when times were good, the damage done when the sophisticated



Citigroup's financial engineers at work

mathematics failed was widespread, and will be felt for years to come.

The words of Lord Byron's *Ode to Napoleon Buonaparte* could just as easily serve as the epitaph for the death of financial engineering:

*Is this the man of thousand thrones,
Who strew'd our earth with hostile bones,
And can he thus survive?
Since he, miscall'd the Morning Star,
Nor man nor fiend hath fallen so far.*

The Stock Markets-Reasons for Hope

As we view the damage done to the stock market over the past 12 months, we have begun to uncover reasons to be optimistic. Probably the single most important reason to take heart is that this country has dealt with many crises before, many worse than the present one. In 1974, Nixon resigned under a black cloud, closing the book on the constitutional crisis he helped create. The S&L crisis in the late 1980s saw many savings and loans go down the drain, including some well-known Colorado institutions.

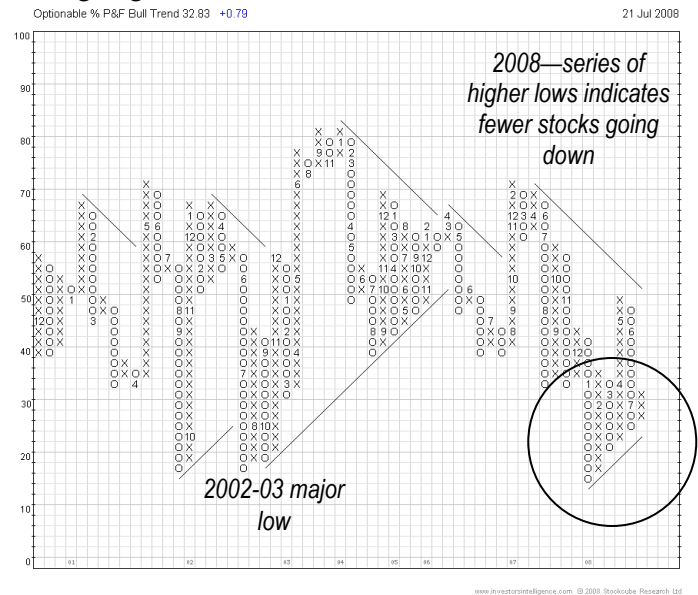
Recovery has never been a matter of sitting about waiting for good times to roll 'round again, but has been a testament to our ability to *adapt*. America, for all its warts and problems, is very good at adapting, and will work through its predicaments on its own. We're not very good at waiting for government to "fix" things (despite being labeled a nation of whiners by Phil Graham).

We have adapted rapidly to high oil prices, as people have switched to mass transit, cut back on driving, and embraced hybrid cars. This won't be an instant solution, but it does exemplify our ability change quickly.

Looking at the markets on a more micro-level, we see the following reasons for hope.

First, a lot of damage has already been done to stocks. Today's bear market has been going on for over a year, as the financial stocks peaked in early 2007, and the remainder peaked in the summer. The media has only covered the harrowing decline of the marquee stocks such as Bear Stearns, Countrywide Credit, Citigroup, Fannie Mae, and Freddie Mac, and has overlooked the fact that the bear market was well advanced before the worst news hit in January. This has given investors plenty of time to adapt to circumstances.

Another curious trend, again overlooked by an oblivious mass media, is that many stocks have stopped going down. This is clearly an important step to the recovery of stock prices. The chart below shows the percentage of common stocks that are on buy signals, using the point-and-figure method of charting. Note how the recent lows are ascending, indicating that fewer and fewer stocks are giving sells, despite the constant drumbeat of bad economic news. If the future is so dismal, why are fewer stocks going down?

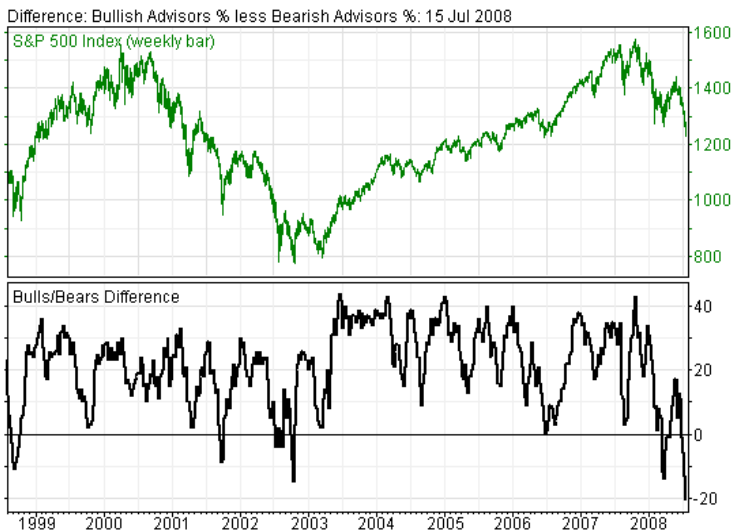


A third factor is that insider buying has been occurring at a pace not seen since the lows of 1994-95. Corporate insiders are presumed to know their companies well, and may be a better judge of value than outside investors. Sporadic insider buying doesn't mean much, but when it occurs in broad and consistent fashion, as it is now, investors should take heed of the message being sent.

Fourth, investor sentiment is not just negative, it is downright depressed. This is perfectly understandable, given the losses and anxiety produced over the last year. However, a high degree of bearishness and skepticism are a necessary ingredient to make a stock market low. An old Wall Street saying goes "The market climbs a wall of worry." Worried investors have typically sold out, and have cash in their pockets. As investors slowly become convinced an emerging bull market is for real, they put that cash to work by buying stocks, bidding up prices. A virtuous cycle is thus created, as higher prices beget more demand, until everyone is fully invested, exhausting their cash and the demand for stocks. Of course, everyone is bullish and optimistic at this point, because they have been making money. Fear of risk is nowhere to be found. A top is thus formed, the excesses

of the previous bull run are wrung out by declining prices, and the cycle starts all over again.

Currently, we are witnessing a 14-year high in the level of bearishness, not seen since 1994 (remember when



At minus 20% the Bullish minus Bearish difference is at a 14-year extreme. This is bullish for the future.

Orange County, CA went bankrupt? That was the last time investors were this bearish). That was also the precursor to the period when the Dow Industrial rose from about 4000 to nearly 12,000 (1995-2000). While not predicting a repeat of that stellar run, today's level of pessimism indicates there is lots of cash on the sidelines that will be put to work in the next 12-18 months.

Finally, though the popular Dow Jones and S&P 500 indexes are grabbing all the headlines, it's important to observe that other broad indexes are not going down to new lows. The Dow and S&P are stuffed with financial stocks, and this has contributed greatly to their poor showing. Financials were about 20% of the S&P index in early 2007, and have shrunk to about 14% today. A quick glance at the NASDAQ 100, S&P Mid Cap, and Russell 2000 Small Cap indices may also provide a glimpse into the future, as future leaders coming out of bear markets are characterized by their ability to break the pattern of lower lows on their price charts. This is an early sign of a market trying to make a bottom.

Portfolio Strategy

Our strategy for client portfolios is to remain heavily invested through the current period, which we think may prove to be a major low. It may take months for stocks to begin a sustainable rally, but the "mosaic" of factors that typically defines a bear market low are falling into

place. Needless to say, this is extremely uncomfortable, especially with the incessant drumbeat of negative news doing everything to shake our beliefs.

It appears that the multi-year bull market in energy and commodities may be giving way to a shift in leadership to small cap stocks, technology and drug stocks, and US stocks rather than foreign ones. Much of this is a tentative assessment at this point, and will become clearer in the months ahead.

What clients can count on, as always, is that we will invest with our eyes open, taking our cues from observing the markets and the stocks that comprise it, rather than base our strategy on some grand prediction that may not come true. The background research on Napoleon has reinforced our belief that success can breed blindness; blindness to obvious risks, and blindness to one's infallibility. Our aim is to learn from Wall Street's mistakes leading to Waterloo, rather than foolishly repeat them.

