Tillar-Wenstrup
Advisors, LLC

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Newsletter

CREDIT WORRIES…ROUND 2

To many the summer credit crunch was thought to be over. In mid-day trading on August 16th the broad stock market had corrected by 10% before rebounding owing to a rumor of a Fed interest rate cut. Bernanke didn't disappoint by announcing a full "One-Half" percent cut in the discount rate before the market opened on August 17th. The market rallied sharply that day and continued its accent reaching an all-time high in early October.

Unfortunately, the last few weeks have been brutal to most financial stocks as more companies fess up to severely damaged balance sheets. Here is a sampling of year-to-date declines (as of 11-2-07): AIG (-19%), Washington Mutual (-40%), Countrywide Financial (-65%), JP Morgan (-5%), Bear Stearns (-33%), MGIC (-71%), Old Republic (-32%), Freddie Mac (-25%), Ambac (-72%).

The companies with the largest losses are in the middle of the mortgage firestorm. Many of these companies were playing a high-risk game of hot potato with mortgage debt. As long as someone was willing to buy the mortgages they would issue the loans, pass it along, and pocket the fees. The originators didn't really care about credit quality since they did not intend to hold the mortgage. Hence the wide spread use of 'no-documentation' and 'no money down' loans. However, when the credit crisis hit and liquidity dried up, those holding "yet to be placed" low-quality mortgages, suffered big losses.

Some pundits will say there were no warning signs but that is not true. Here is a post from our Blog (www.twadvisors.com/MarketBlog.asp) posted on March 28, 2007:

> For any investor worried about managing risk there is a must-read March 27th article titled Sketchy Loans Abound in the *Wall Street Journal* by Dennis K. Berman.
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> This article highlights the frenzy going on in the overheated debt markets. The comment that really caught our eye was from a Princeton economist who studies market bubbles named Markus K. Brunnermeier. Referring to the banks that make loans and sells them to institutional investors he said, "You try to forecast when the others are getting out. You don't focus on the fundamentals. You focus on the other players."
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> In other words, "the greater fool theory" is alive and well in the bond market. When market players stop focusing on fundamentals and become dependent on the actions of others, prices are no longer tied to value and can become inflated.
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> *At some point these fools will stop buying debt with modest returns and high risk. When this occurs asset markets will likely readjust to lower valuation levels.*

We have also consistently warned that the fall-out from the housing and debt bubbles will take years, not months to work through. However, severe declines such as we have seen often provide fabulous buying opportunities. Our advice is to closely monitor this area of the market for bargains. Keep in mind that it will be virtually impossible to pick the bottom, so a smart strategy would be to invest in small increments over a long period of time.

Our biggest portfolio holding is Warren Buffett's company, Berkshire Hathaway, which is up about 20% this year. The current market turmoil should be a golden opportunity for Buffett. Berkshire has a ton of cash that Buffett wants to deploy, and he is very comfortable with financial companies. We would not be surprised if Buffett took advantage of the tumult in the financial stocks and made a major investment. A good guess would be the financial guarantee business, the epicenter of recent problems. Berkshire's Fort Knox balance sheet and sterling reputation would allow entry into this profitable business with good long-term global growth prospects that historically has been hard to break into.

Despite the bear market in financial stocks, the rest of the market is doing quite well, especially those companies levered to overseas economies. Until proven otherwise the 'global-growth' investment theme is still solidly in a bull market.

The information provided in this article should not be considered a recommendation to purchase or sell any particular security.

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