



## **Congratulations: You made it through a truly ugly quarter!**

Dear Clients and Friends:

April 15, 2008

Our clients deserve an award for getting through the worst quarter in a decade without losing their long-term investment focus. The S&P 500 has declined for five straight months, which hasn't happened since the early 90's. However, the stock market decline was overshadowed by the level of dysfunction in the credit markets. Uncertainty was rampant, inspiring historically significant intervention on the part of the Federal Reserve.

No getting around it – the quarter was bad. However, volatility equals opportunity. We are maintaining our long-term perspective and investing with managers who can capitalize on the opportunities. To put your performance in perspective, here is how the major indices ended.

	<u>1stQ</u>
NASDAQ	-14.1%
S&P 500 Index	- 9.5%
Dow Jones Industrial Average	- 7.0%
Lehman Brothers Aggregate Bond	+ 2.2%

### What Started It All? The Residential Mortgage Bubble Burst

Last year, rapidly rising residential home prices suddenly reversed and declined in most regions. We've all heard that homes are the biggest single investment families make. However, homes are also the most leveraged, and that's where the trouble lurked.

Low interest rates on mortgages at first inspired a refinance boom. However, when the Federal Reserve lowered the Fed funds rate to 1% in 2003, they went too far. Getting a mortgage became so easy that it caused a surge in buying. Early buyers saw home values soar, which attracted speculators. Eventually many mortgage originators loosened their lending standards until nearly 25% of the mortgages originated in 2006 were classified as "sub prime".

In classic bubble fashion, the demand from early buyers fueled rising prices, which combined with loose standards to attract more buyers, which inspired builders to build new and more expensive houses, and so on. Many loans made in the past two years only made sense if home prices continued to rise for the foreseeable future. The cycle ended when the Fed began to raise rates back to "normal" levels.

In late 2006, the rate of families defaulting on their mortgages increased. Financial markets became scared about how high the default rate would rise, how far home prices could fall and whether the housing bust would drag down the rest of the economy.

### The Domino Effect of Mortgage Defaults. The Role of Synthetic Mortgage Pools

The pervasiveness of new synthetic mortgage pools introduced considerable uncertainty into what historically would have been a "normal" credit tightening cycle. Collateralized

Mortgage Obligations, Collateralized Debt Obligations, Collateralized Loan Obligations- whatever you call them, they were newfangled products invented by investment banks to satisfy income-hungry fixed income investors.

Issuers of these privately placed “structured” products multiplied the positive and negative effect of the surge in home mortgages. For every real mortgage pool that was offered to fixed income investors, a “daisy chain” of two or more synthetic mortgage pools were created that would pay the investors based on the performance of the real mortgage pool. In effect, the issuers were creating money much in the way commercial banks create liquidity in the economy.

Even though the real mortgage pools contained a mix of both investment grade and less than investment grade mortgages, the bond rating agencies (Standard & Poors, Moody’s, etc.) rated the real and synthetic mortgage pools as investment grade. The agencies had plenty of history about the default rates on real mortgage pools to guide them, but there was little history for the synthetic pools. The new products had not been tested during a rough market, much less a bubble/bust scenario. Fixed income investors worldwide took the ratings at face value. It was virtually impossible to figure out what collateral lay behind these synthetic investments.

When the housing bubble burst and investors began to realize the magnitude of risk, both the real and untested synthetic mortgage pools lost the confidence of financial institutions and investors. The privately placed structured products created an unknown amount of leverage in the system. By the first quarter of 2008, institutions around the world became distrustful of almost any kind of fixed income investment except U.S. Treasuries backed by the government.

Credit market after credit market suddenly dried up. Not only could a seller not get a bid for the real and synthetic mortgage pools, it became difficult to sell municipal bonds, corporate bonds and almost anything else. A flight to the safety of Treasuries drove their yields so low that municipal bond yields exceeded Treasuries on a *nominal* basis during the first quarter. This was unprecedented. Credit spreads widened rapidly.

Financial institutions would not trade with each other, preferring to hoard their capital and build up their own balance sheets. Standards for all types of loans became strict to the point of being virtually unobtainable from many institutions. The markets today cannot even put an agreed value on the synthetic pools.

Jobless claims rose, in a clear sign that the U.S. economy is slowing down.

The loss of confidence hit highly leveraged investment banks hard. Financial markets function on trust that obligations by each player will be honored. Bear Stearns was the most high profile example of a firm that lost the trust of other financial institutions.

#### The Federal Reserve to the Rescue

To stimulate the economy, Congress quickly passed a bill to send a tax rebate to anyone who files a 2007 tax return. However, the financial industry perceived the effort as having little effect.

As the only institution with the necessary power and tools, the Federal Reserve was on the hot seat to ease the pressure and restore confidence. The Fed made more liquidity available to the banks and lowered interest rates to stimulate credit markets. Specifically, the Fed took the following actions:

- Lowered the Fed Funds rate from 4.25% to 2.25%.
- Lowered the Fed Discount rate from 4.75% to 2.5%.
- Allowed security dealers such as Goldman Sachs, Lehman Brothers and Morgan Stanley to borrow directly from the Fed -- the first time that power has been used since it was authorized at the time of the Great Depression.
- Offered to exchange high quality Treasuries for the illiquid mortgage-related assets on bank balance sheets.
- Backed the successful reduction in the capital holding requirements of Fannie Mae and Freddie Mac to allow them to hold more mortgages.
- Proposed that mortgage holders preemptively write down the value of mortgages to keep homeowners from defaulting.

In March, when Bear Stearns' problems threatened to set off a domino collapse of the financial system, the Federal Reserve intervened by forcing a sale of the firm to J.P. Morgan Chase to avoid bankruptcy and the domino effect it would have on other institutions. Equity holders were all but wiped out, but bondholders were saved and credit markets stabilized. The Fed stated its intention to lower rates to whatever extent necessary to support confidence and economic growth.

#### Negative Fallout From The Fed's Action

The threat of a financial system meltdown has forced the Fed to abandon their vigilant stand against *inflation* until after the credit crisis is past. Rapidly reduced interest rates make the U.S. dollar less competitive on world currency markets. While the latest Fed action is not the sole cause, during the quarter the *dollar continued to decline*, causing upward pressure on oil and other dollar-denominated commodities. Oil reached \$110 per barrel. Other commodity prices also surged.

#### Does The U.S. Financial System Need Fixing?

We will leave it to smarter people to decide, but it seems unusual to us that the U.S. could experience bubbles of such magnitude as those of 2000 and 2008 in such quick sequence. Only eight years after the largest stock market bubble since 1929, we are again going through an even more damaging housing-related bubble.

Treasury Secretary Henry Paulson may be correct in proposing that the Fed extend commercial bank-type regulatory authority over the investment banks on Wall Street. Since they have become what many call "shadow banks" by assuming similar money creating functions, the institutions may deserve to be regulated differently.

#### When Will This Be Over?

It is unreasonable to think that a bubble of such worldwide scope and magnitude could be cured within only two or three quarters. It could take several quarters for the markets to clear the excesses. This is particularly true given the relatively illiquid nature of real

estate. Selling a foreclosed home is a more time consuming thing than selling a stock or bond.

Historically, the actions of the federal government and the Fed during presidential election years have provided some support for the economy. The expectation of additional intervention may help stabilize the markets this year. We expect the fixed income and stock markets to bounce around as mini-crisis situations are dealt with by the financial system.

#### How Does All This Change Summit's Investment Policy?

The situation calls for small, measured shifts in our investment tactics, not a wholesale change in our investment policy or philosophy. We reaffirm our principals: be a long-term investor, avoid market timing, act on reversions to the mean, fish in many ponds, and partner with exceptional fund managers who understand the fundamental value of the companies in which they invest.

We are changing our fixed income tactics. The yield curve has shifted from inverted to normally sloped, and credit spreads have widened. Unlike the past two years, bond fund managers should again be able to provide value, net of their fees. Therefore, we have abandoned the strategy of investing directly in very short individual Treasuries, Agencies and FDIC-insured CDs. As those instruments mature, we are investing the proceeds in our best investment grade bond funds.

We are also allocating a portion of client fixed income investments to our "total return" bond funds that can invest in both investment grade and non-investment grade bonds. Worldwide, all types of bonds are being re-priced, central banks are raising and lowering rates and currency values are fluctuating. We believe the dysfunctions worldwide will allow our managers to capture good values for our clients. If we believe that rising inflation has become a long-term threat to fixed income returns, we may introduce an inflation protected bond fund.

A few exceptional, but closed, equity mutual funds have reopened because they are seeing more investment opportunities. We are adding some of these to our select list and our client portfolios.

As we did in the first quarter, we will continue to use market corrections to phase new client investments into the stock market. At current values, we believe stock returns will be superior to bonds over the long-term. If values decline further, we may over weight equities.

Thank you for your faith in us. Please contact your Summit financial advisor with your questions.



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