



INVESTMENT STRATEGIES

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What Happened? (Part 2)

What we learned about avoiding the next great recession: an essay

In last month's strategy piece we discussed a variety of factors that we believe caused or worsened the Great Recession. This month, we want to discuss the knowledge gained from this experience. From our point of view, the impact of unintended consequences was the main lesson learned. Our economic system is so complicated that even well thought out and well intentioned legislation, rules and beliefs can have unexpected and often detrimental consequences. Further, it may be years before the full impact of such actions becomes apparent.

As we noted in February, the economic distortions that eventually led to the recession likely began more than 30 years ago and grew over time. Such distortions are typically the result of companies, individuals and other participants in the economy changing the way they operate to maximize their economic returns in light of new rules.

Think of the Cash for Clunkers program as an example. The program resulted in accelerated car purchases as buyers rushed to take advantage of cash being offered for a short period of time. This likely took away future sales and possibly resulted in the destruction of past capital investment before its true value was recognized.

The Great Recession was largely precipitated by the collapse of the housing market due to a change in behavior by buyers, which amounted to a higher number of purchases than was economically appropriate. Buyers who were not appropriate purchasers bought houses, or those appropriate buyers bought more house than they could really afford. All of the incentives to buy houses -- tax benefits, low down payments required, subsidized financing through various government sponsored enterprises, requirements for banks to lend in disadvantaged neighborhoods -- led to much higher than usual levels of home ownership and higher demand for houses than would have been normal.

Add to that other forces -- companies changing their business models, the belief that home values never decline, an influx of speculators, a decline in credit requirements for buyers -- and you have a recipe for disaster. Housing prices increased at a rate well above average, which pushed home affordability above what it should have been and forced out many buyers. This eventually lowered demand. When all of these forces collided, the decline in house prices was inevitable.

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With these factors in mind, what additional conclusions can be drawn? An important one is that the losses incurred when such bubbles pop will usually equate to the level of profits made on the other side. When these profits are extremely large and the distortions occur over a long period, expect the pain on the other side to be similar.

Also expect much of the cause of the damage to be concealed, as those complicit in the precipitation of the actions and those responsible for the legislation that helped to engender the inflation of the bubble cover themselves. Government Sponsored Enterprises (GSEs) Fannie Mae (FNM-\$1.01) and Freddie Mac (FRE-\$1.22) are one illustration. These GSEs were formed by the US government and nurtured by politicians from both parties to assist homebuyers in the mortgage market, and were organized as quasi-private/public hybrids. The actions of FNM and FRE are likely to result in hundreds of billions of dollars in losses for tax payers.

However, this impact has been hidden from view. The two companies were taken over by the government rather than being allowed to fail, and politicians have chosen not to disclose the losses associated with the two companies. Unlike with public companies, there is no disclosure requirement with FNM and FRE.

While the intention to help homeowners is/was laudable, there is, once again, the impact of the unintended consequences when the government attempts to influence the market.

Finally, related to this is the fact that, in general, those trying to defend themselves will always take a simplistic and self-serving methodology in blaming others instead of acknowledging numerous factors as causing the recession. The most noticeable bogeyman used by politicians for the current situation is the "greedy banker", who is only one of the forces that exacerbated the recession.

If there are obvious ways to avoid recessions, why do we continue to have them? This is a great question that cannot truly be answered, any more than we can determine when to intervene in the market to help deflate bubbles before they become the types of events that result in recessions or other economic dislocations.

For example, Alan Greenspan's speech on "Irrational Exuberance" took place more than three years before the peak of the internet bubble and NASDAQ market prices. While Mr. Greenspan was right eventually, if he had taken steps to deflate the bubble in 1996, he probably would have been excoriated by the press and investors.

Since timing the end of such bubbles is virtually impossible to do, so is identifying a recession before it occurs. With this in mind, the logical path is to do everything to lessen the impact of the bubble as it begins to deflate. In order for the economy to maximize its growth over time, ups and downs are inevitable.

In our view, the reason our economy has seen the amount of growth it has since the Union was founded is that it has been allowed to grow largely unfettered, through both good times and bad. At this point, we feel the worse risk would be over-regulating the markets, which could result in lower long-term growth for the economy.

Part 3 will discuss the worldwide impact and interconnections of the Great Recession and what was done to limit the damage from it.

Additional information is available upon request.

Analyst Certification

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Buy - We believe the stock has significant total return potential in the coming 12 months. **Long-term Buy** - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues. **Neutral** - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise. **Underperform** - We believe the stock is vulnerable to a price decline in the next 12 months.

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1 - A large cap, core holding with a solid history. **2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks. **3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage. **4** - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base.

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	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Rating				
Buy	47	27%	2%	98%
Long-term Buy	37	21%	0%	100%
Neutral	84	48%	6%	94%
Underperform	5	3%	0%	100%
Not Rated	1	1%	0%	100%

As of 5 March 2010

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