ATLANTIC ADVISORS, LLC
ASSET MANAGEMENT

What It Would Take For Me to Become Bullish

October 13, 2008 Newsletter

Ticking away the moments that make up a dull day
You fritter and waste the hours in an offhand way.
Kicking around on a piece of ground in your home town
Waiting for someone or something to show you the way.

Tired of lying in the sunshine staying home to watch the rain.
You are young and life is long and there is time to kill today.
And then one day you find ten years have got behind you.
No one told you when to run, you missed the starting gun.

So you run and you run to catch up with the sun but it's sinking
Racing around to come up behind you again.
The sun is the same in a relative way but you're older,
Shorter of breath and one day closer to death.

Every year is getting shorter never seem to find the time.
Plans that either come to naught or half a page of scribbled lines
Hanging on in quiet desperation is the English way
The time is gone, the song is over,
Thought I'd something more to say.
Time-from the album, Dark Side of the Moon—Pink Floyd, 1973.

How Did We Get into This Mess?

The question I get asked the most lately is, "How on Earth did we get into this mess in the first place?" The answer, plain and simple, is greed.

I have stated numerous times that markets world-wide and throughout the centuries are dominated by individuals that cannot seem to shake the two simplest of emotions—fear and greed. Markets tend to overshoot in both directions as investors experience these emotions, which is why I live by the mantra, "buy from the fearful and sell to the greedy."

I can trace the evolution of this greed, during my lifetime, back to a fateful day on May 1, 1975. A day known as "May Day". Until that day, stock brokers charged a fixed commission on all transactions; there was no negotiation. In order to promote competition, the SEC ended the fixed schedule commissions which had been in place since the signing of the Buttonwood Agreement in 1792 and the origins of the New York Stock Exchange. It is believed that over the next few weeks, commission rates dropped in half.

This was a wonderful event for investors, but a bad day for Wall Street as one of their chief sources of revenue had now started down the road of deflation.

When I began my career as a retail stock broker in 1981, commission rates were still rather high and with interest rates in the mid to high teens, even bond commissions were high. In fact, the very first bond trade of my career was a sale of $25,000 Sayreville, New Jersey School District municipal bonds, and I was paid a $750 commission (3 percent). As my career transitioned to institutional sales and trading, markets became more transparent and commission rates plummeted even further. I recall my last transaction on the "sell side" in 1997 of $25 million of US Treasury Notes for a commission of $250. Talk about deflation. You can imagine that there is not much incentive to live in a world where you trade $25 million of securities, assume the inherent risks of a trade failing or a mistake being made, and only be paid $250 for that risk. This was no longer a wonderful way to spend my day.

Brokerage firms saw this trend developing and began transitioning the traditional stock broker into "financial advisors". Financial advisors would typically advise their clients to diversify their portfolios into various styles, utilizing a group of pre-screened investment managers in "wrap accounts". So rather than charge commissions on individual securities, portfolios were concocted to diversify their client's portfolios and still be able to charge fees as high as 3% per year.

As an aside, a couple of the wrap program trading desks were my clients while I was an institutional salesman and, to be frank, I was never that impressed with what I saw being done for clients. This is what led me to becoming a Registered Investment Advisor in 1997. To me, the wrap programs looked an awful lot like a bunch of "mutual funds in drag" but with a higher cost structure.

In addition, there were closed end funds, which are just publicly traded mutual funds, that raise a fixed amount of capital through an IPO whose shares then trade as a stock on a listed exchange. Closed end funds, however, carry commissions and fees that equate to as much as 7% percent of the initial Net Asset Value, which means that the investor paying the IPO price was left with about 93% of their money at work on day one.

On top of the 7% in fees, the funds were often leveraged by 50% in order to enhance the yield via sales of Auction Rate Preferred Stock (ARS), the very same vehicle that stranded so many investors earlier this year, and the same vehicle that so many brokerage firms ended up settling lawsuits on for vast amounts of money. We commented on this back in February in The Ugly Side of an ARS.

Way back in June of last year I highlighted the structure of closed end funds and the dangers that lurked in The Anatomy of a Closed End Bond Fund. Now that these dangers have exposed themselves and the prices have gone through a massive correction, we are finding many opportunities as we begin to buy a few select closed end funds that trade at as much as 40 percent discount to NAV. We may be early, but buying distressed assets at huge yields and at huge discounts to NAV is my cup of tea.

So I suppose one might say that I am slowly becoming more bullish in very specific areas and that this is a matter of price… that because we have the cash when others sell more out of fear, rather than due to a rational investment decision.

In summary, we can trace the lineage of this greed back much further than sub-prime in our lifetime, and even though it wasn't the beginning of this deadly sin known as greed, the brokerage industry helped get us to the point we find ourselves in now. The traditional revenue streams dried up and yields dropped far enough to entice investors, both individuals and institutions, to stretch for yield, ignore prudence, and succumb to ever greater amounts of greed.

Where We Are Now

Once traditional Investment products fell by the wayside, investment banks found more and more esoteric vehicles to create and distribute. As the housing market entered its parabolic state, lending standards fell dramatically. In May 2005, banks were warned about their lending practices from the OCC (Office of the Comptroller of the Currency), Federal Reserve, FDIC, Office of Thrift Supervision and the National Credit Union Administration (Home Equity Lending Guidance to Banks). Even still, banks continued to lend in a reckless manner that ended with the bursting of the housing bubble.

If it were not bad enough that the loans were being made in the first place, Wall Street was then encouraged by the SEC in early 2006 to lever their balance sheets up to 30-40x shareholder equity, up from a more traditional 3-4x shareholder equity. In this push to higher leverage, the world of esoteric CDO's (Collateralized Debt Obligations) was born. With interest rates and credit spreads at historically low levels, it should come as no surprise that the underlying investments that were carved up into these CDO's turned out to be horrible investments, even though they were huge sources of income for brokerage firms.

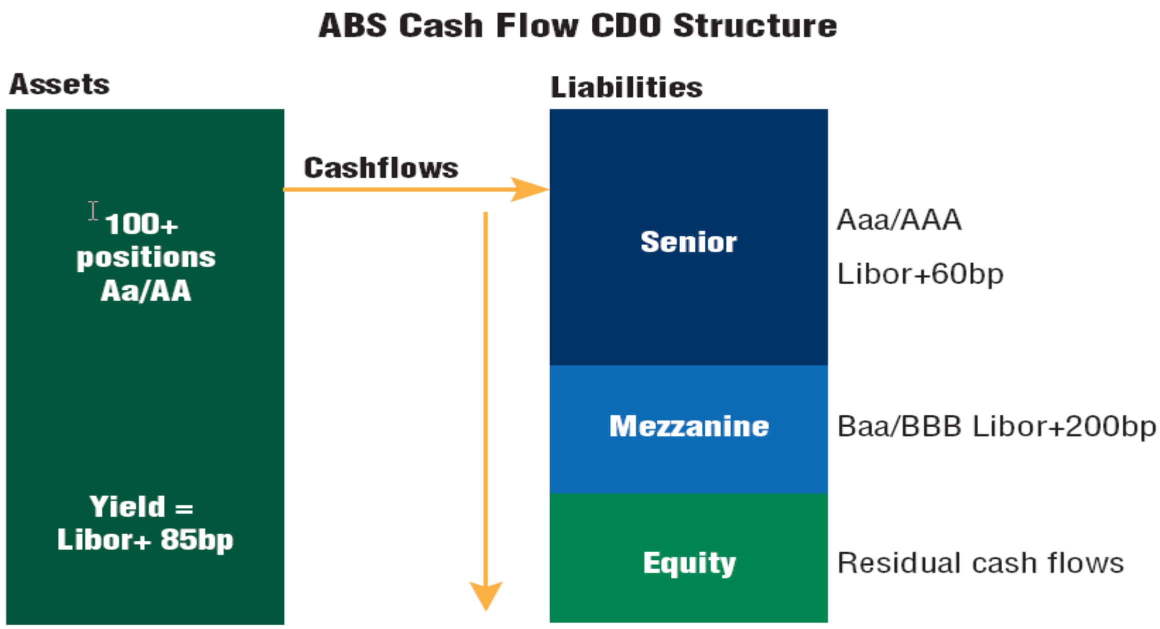
As I have been writing for years how these practices would come back to bite brokers in their hind quarters, I am not overly surprised to see that there are now exactly ZERO investment banks left in this country that are not either part of a bank, converted into a bank or have gone bankrupt.

Greed is a horrible thing and it caught up to all of the investment banks. All one must do is take a look at a chart of the AMEX Securities Broker/Dealer Index to get a sense of just how bad it has been for this industry.

AMEX Securities Broker/Dealer Index (in logarithmic terms)

Copyright Bloomberg, LP 2008

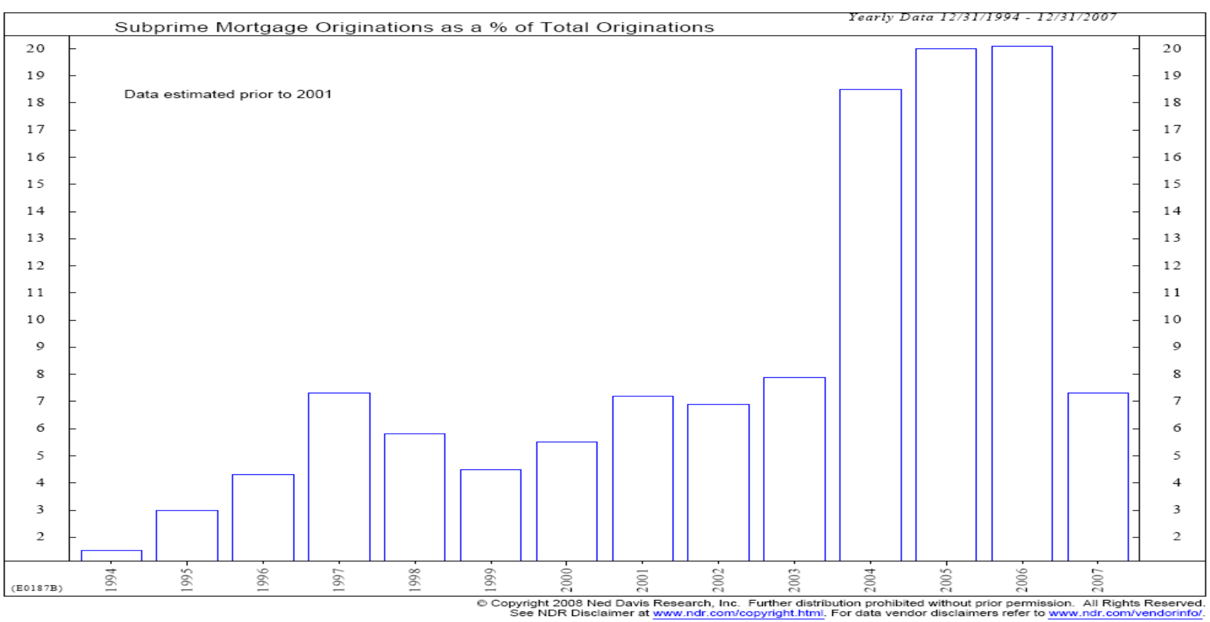
The typical CDO structure of an Asset Backed Securities deal is shown below. In its simplest form, a CDO takes the cash flows from the assets (let's use sub-prime mortgages as the "assets" in this example) and distributes them in turn to the creditors of the structure on a preferred basis. The senior creditors receive all of the initial cash flow on a priority basis and therefore receive the lowest yield. Lower priority creditors receive the last amounts of uncertain cash flow and are in turn given higher expected returns. As the assets on the left side become "impaired" (seriously delinquent, foreclosed or in receivership), the higher grade tranches become impaired or downgraded and then lose value.



What we must remember is that when one takes the lowest quality assets, sub-prime mortgages, and then levers them and carves them up for the sole benefit of the broker/dealer, greed can play a serious role. Risk does not magically disappear, but instead is magnified and hidden in plain sight behind the elaborate structures.

Unfortunately, when these structures stop working, there can be serious consequences for the owners of the securities – the banks, brokers, hedge funds, mutual funds, credit unions, insurance companies, etc. The ability of these structures to issue low quality mortgages enticed mortgage originators to make ever more lousy loans. It should come as no surprise that issuance of these sub-prime loans peaked in 2006 as a percentage of all mortgage originations.

Subprime Mortgage Originations as a % of Total Originations



What followed all of the leverage and all of poor lending has been a spike in delinquency rates at both the subprime and prime level, as depicted in the chart below. This is now spreading to the commercial real estate space and to virtually all other areas of credit.

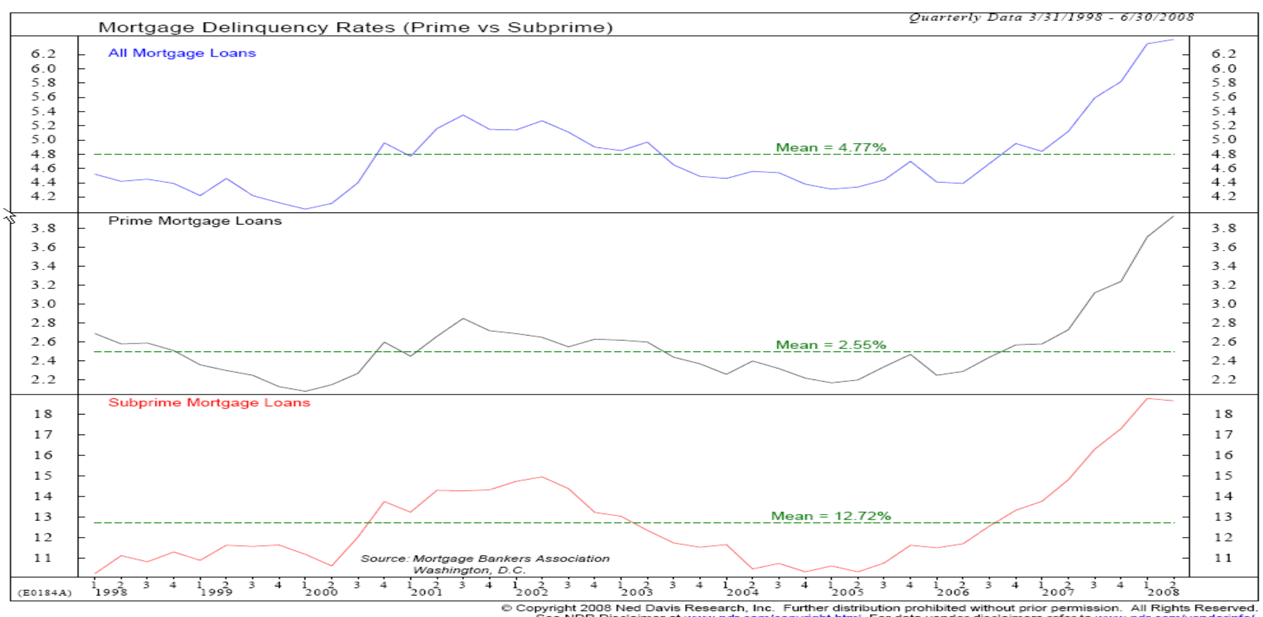
The Credit Crisis is picking up steam—at a level that frightens even the most cautious investors (yours truly included). It seems that each weekend we see more Government intervention/intrusion (as I write this, the U.K. has just been forced to inject liquidity into the Royal Bank of Scotland and HBOS, two of Britain's largest banks). Whether it is Fannie and Freddie being nationalized at our expense, a $700 billion "bailout" of our banks, or Treasury Secretary Paulson suggesting he wants to inject liquidity directly into U.S. banks, since banks will not do business with each other or lend. Mr. Paulson apparently thinks that using the money of "We the People" will solve the problem.

This reeks of Socialism and is delaying the "business cycle" as I used to understand it. In my humble opinion, the longer the cycle is delayed, the longer it will take for confidence to be regained in the system, not the opposite as government official mistakenly believe. After all, haven't they noticed that every time they intervene/intrude, the credit markets and equity markets sell off right in their face? I certainly have noticed this and it lead me to the conclusion that intervention/intrusion is the absolute worst direction to go.

I say let markets be markets, that those that have made mistakes suffer and that those that have sinned pay for their sins. But not with my money! I have spent my adult life being prudent, saving money, investing wisely (most of the time) and I've spent my career being prudent with other people's money. It should be my choice if I want to own impaired CDO's, Fannie/Freddie/AIG and a bunch of impaired bank stocks, not the choice of the Fed, Treasury and Congress.

Perhaps injecting equity into banks around the world will encourage them to lend, perhaps not. More likely, it may be the cushion necessary to allow banks to write down/write off assets and return to lending. The question that lurks in my mind is, lend to whom? Consumers have over-consumed for so long that I wonder if freer credit will actually allow the economy to grow.

Mortgage Delinquency Rates



Why Have Stock Prices Fallen So Quickly?

The pace and severity of the decline in global stock prices has taken many by surprise. I have to admit that although I have maintained a target for the S&P 500 of 500-650 for quite a while now, I too have been a bit surprised by the speed at which the avalanche of stock prices has taken place.

Then again, I have stated for months that we were living in a world of a Tale of Two Markets, where the credit markets were dying a slow death and the stock market proceeded merrily along. So it is my opinion that the stock market has simply caught up to the credit market, a market with little liquidity and loads of assets for sale due to mutual and hedge fund redemptions, in addition to margin calls.

The chart below of the S&P 500 says it all—the uptrend from the 1982 was broken and support line after support line has been broken. It is said that, "in bear markets, support exists to be broken." The next line in the sand is in the 750-775 area, the area that was the bottom of the previous bear market low in late 2002-early 2003. But if that support line is broken, it brings into view the uptrend line from the 1974 low in the 500-550 area. I have no idea if this will occur or if markets will bounce from historically oversold conditions, but will stand by and watch. Please note that we do not currently maintain a position in the S&P, neither long nor short.

Long Term Chart of S&P 500 in logarithmic terms

Copyright Bloomberg, LP 2008

1560 Orange Avenue, Suite 150 Winter Park, Florida 32789 P: 407-998-8788 | F: 407-998-8790

<u>Summary: What would it Take For Me to Turn Bullish on Equities?</u>

- **Credit markets need to normalize and spreads tighten.**
- **Allow markets to function without government intervention/intrusion.**
- **Equity valuations need to become oversold, not just stock prices.**
- **A return to "Social Darwinism" – allow the weak to fail.**
- **A rise in the personal savings rate, even at the expense of recession.**
- **Leverage reduced at the corporate and consumer level.**
- **Presidential cycle to reach a low (October 2010).**
- **LIBOR to normalize.**
- **Most importantly, we need TIME to heal the market, not just price.**

When I consider the bullet points above, I think of the lyrics at the outset of this piece. I believe that the markets have not been permitted to react on their own in a traditional manner since 1997 and the Greenspan days. Instead, we suffer from chronic dependence on a Fed/ECB/Treasury that seems more interested in asset price increases than they do in price stability and normal business cycles.

Government officials have the fight of their life on their hands and it appears that each time they intervene it delays the ultimate economic outcome, and possibly even reduces the bottom in equity prices further than I can imagine.

The avalanche in equity prices has begun and when I think of the amount of assets that have been lost in a short period of time, I shudder. Pension plans around the globe are now woefully underfunded. In addition, mutual funds and hedge fund redemptions will continue into year-end.

Earnings estimates will fall unless credit spreads and LIBOR normalize quickly. We are about to possibly enter a period of substantially higher tax rates on high wage earners. Margin clerks are busy asking traders to sell, and mutual funds and 401 (k) plans have liquidity and credit problems. Credit issues are now spreading to commercial and construction loans not to mention that credit card delinquencies are on the rise. Unemployment is likely certain to increase further and jobs will be lost to emerging markets.

The point here is not to depress anyone or to sound like a spoil-sport. Instead, we must face the issues at hand and deal with them in a fashion that is not a constant "Band-Aid". The only way stocks could be deemed "cheap" here is if we believe the Wall Street S&P 500 estimates of 2008 of $75 per share are correct. We actually think 2009 earnings will come in around the $55-60 range at best, which would suggest an index price target (if a "normal secular bear market bottom" P/E ratio of 8 to 10 times earnings) that coincides with the price on my S&P 500 chart of 500-600.

Bounces along the way are inevitable, but for a true bottom to be put in place, some more work needs to be done to the downside.

This may be a TRADER'S PARADISE. But investors beware!

Bennet Sedacca,
President

LEGAL AND OTHER INFORMATION. Any information, data, statements, opinions, or projections made in this Newsletter may contain certain forward looking statements, projections and information that are based on the beliefs of Atlantic Advisors as well as assumptions made by, and information currently available to, Atlantic Advisors. Such statements in this Newsletter reflect the view of Atlantic Advisors with respect to future events and are subject to certain risks, uncertainties and assumptions (including, but not limited to, changes in general economic and business conditions, interest rate and securities market fluctuations, competition from within and without the investment industry, new products and services in the investment industry, changes in customer profiles, and changes in laws and regulations applicable to Atlantic Advisors). Should one or more of these or other risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in this Newsletter. Furthermore, although carefully verified, data is not guaranteed as to accuracy or completeness. Any quotations of individuals other than the authors or providers of this Newsletter are provided for informational purposes only and their accuracy and veracity are not guaranteed. The statements, opinions, and/or data expressed in this Newsletter are subject to change without notice based on market and other conditions. This Newsletter is based on information available as of the time it was written, provided, or communicated and Atlantic Advisors disclaims any duty to update this Newsletter and any content, research or information contained therein. Accordingly, neither Atlantic Advisors nor its principals or affiliates make any representation as to the timeliness of any information in this Newsletter. As a result of all of the foregoing, inter alia, neither Atlantic Advisors nor its principals can be held responsible for trades executed by the recipients or viewers of this Newsletter based on the statements, projections, research, or any other information of any other kind included therein. ***Investments in securities are speculative and involve a high degree of risk; you should be aware that you could lose all or a substantial amount of your investment if you attempt to apply any of the information in this Newsletter***.

Atlantic Advisors is not registered as a securities broker-dealer either with the U.S. Securities and Exchange Commission or with any state securities regulatory authority or with any foreign country. This Newsletter should not be construed by anyone as Atlantic Advisor's solicitation or offer to effect or attempt to effect transactions in securities or the rendering of personalized investment advice (or an offer thereof) for compensation. This Newsletter, and any information and research contained herein, do not represent recommendations of investment advice to buy or sell securities or any financial instrument nor are they intended as an endorsement of any security or investment. **This Newsletter is for informational purposes only and any watch list, portfolio, trading signal or information contained in this Newsletter represents the writer's or provider's own investment opinions, and should not be construed as personalized investment advice. Atlantic Advisors has not assessed, verified, or guaranteed the suitability of any particular investment to any personal situation and the reader of this Newsletter bears complete responsibility for its own investment research and should seek personalized advice from a qualified investment and/or tax professional prior to making any investment decisions.** Atlantic Advisors may only transact business or render personalized advice, and offers of service can only be made, in those states, countries, and/or international jurisdictions where Atlantic Advisors is registered or where an exemption or exclusion from registration is available. Nothing herein is an offer of any service that is not legal for offer into any particular jurisdiction with Atlantic Advisor's current licensure (if any).

Atlantic Advisors and its respective officers, directors, employees, clients, and/or associated persons may have positions in, and may from time to time make purchases or sales of, the securities discussed or mentioned in this Newsletter. Furthermore, Atlantic Advisors and their respective officers, directors, employees, clients and/or associated persons may implement any strategies discussed in this Newsletter before or after such strategies are disclosed to recipients of this Newsletter. The profitability of any strategies communicated through this Newsletter may depend upon a limited number of persons implementing and knowing about the strategies. As a result of Atlantic Advisors and their respective officers, directors, employees, clients and/or associated persons trading and implementing the securities and strategies, respectively, discussed in this Newsletter, before or after such securities or strategies are discussed or disclosed to recipients of this Newsletter, such recipients may face decreased or no profitability and increased competition in the marketplace when seeking to implement such strategies or trade such securities. The principals of Atlantic Advisors might not purchase or utilize in this Newsletter, or make any reference therein to, the securities or strategies, respectively, used for any client affiliated with Atlantic Advisors or its principals.

NO WARRANTY. ATLANTIC ADVISORS, ITS AFFILIATES, AND THEIR OFFICERS, DIRECTORS, PRINCIPALS, AGENTS AND EMPLOYEES MAKE NO REPRESENTATIONS OR WARRANTIES, EXPRESS OR IMPLIED, REGARDING THE SUITABILITY OR OTHER CHARACTERISTICS OF THE INFORMATION AND MATERIALS CONTAINED IN OR PRESENTED THROUGH THIS NEWSLETTER. ALL SUCH INFORMATION AND MATERIALS ARE PROVIDED "AS IS", WITHOUT ANY WARRANTY OF ANY KIND. ATLANTIC ADVISORS HEREBY FURTHER DISCLAIMS ALL WARRANTIES AND CONDITIONS WITH REGARD TO SUCH INFORMATION AND MATERIALS, INCLUDING ALL IMPLIED WARRANTIES AND CONDITIONS OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE TITLE, NON-INFRINGEMENT AND AVAILABILITY.

LIMITATION OF LIABILITY. IN NO EVENT SHALL ATLANTIC ADVISORS, ITS AFFILIATES, OR THEIR OFFICERS, DIRECTORS, PRINCIPALS, AGENTS AND EMPLOYEES BE LIABLE FOR ANY CLAIMS, LIABILITIES, LOSSES, COSTS OR DAMAGES, INCLUDING DIRECT, INDIRECT, PUNITIVE, INCIDENTAL, SPECIAL, CONSEQUENTIAL DAMAGES (INCLUDING BUT NOT LIMITED TO, LOST PROFITS OR TRADING LOSSES), OR DAMAGES OF ANY KIND WHATSOEVER ARISING OUT OF OR IN ANY WAY CONNECTED WITH THIS NEWSLETTER (INCLUDING WITHOUT LIMITATION, THE CONTENT, INFORMATION, RESEARCH OR SERVICES INCLUDED THEREIN) WHETHER BASED ON THEORIES ARISING IN CONTRACT, TORT, STRICT LIABILITY OR OTHERWISE. SUCH LIMITATIONS APPLY EVEN IF ATLANTIC ADVISORS, ITS AFFILIATES, OR ANY OF THEIR OFFICERS, DIRECTORS, PRINCIPALS, AGENTS OR EMPLOYEES HAVE BEEN ADVISED OF THE POSSIBILITY OF DAMAGES.