

Investing in a World of Intervention

December 08, 2008 Newsletter

*On a long and lonesome highway
east of Omaha
You can listen to the engine
moaning out its one lone song
You can think about the woman
or the girl you knew the night before,
but your thoughts will soon be wandering
the way they always do
when you're riding sixteen hours
and there's nothing much to do
and you don't feel much like riding
you just wish the trip was through*

*So, here I am,
on the road again
There I am
up on the stage
And here I go
playing star again
There I go
turn the page*

Bob Seger & the Silver Bullet Band-"Turn the Page"

[Click here to watch the video for
"Turn The Page"](#)

Will Turning the Page be a Silver Bullet?

I am not sure what makes people believe that the action of turning the calendar to a new year will act as a "magic bullet" for them. I have to admit to having my own New Year's Resolutions over the years – typical promises to myself to lose weight, spend more time with family and friends, etc, etc. I don't know anyone that, as the ball falls in Times Square each year, has not had a resolution to make things better for themselves. Yet, lo and

behold, when we wake up on January 1, not much has changed, right? The thoughts of resolutions start to fade into the distance and most folks revert to their ways of old. Present company most definitely included!

When the history books are written, 2008 may very well be remembered as, "The Year of Intervention". For those that have read some of my previous pieces, I may seem a bit whiny or frustrated, and indeed you would be correct! Winding one's way through this market and economy is challenging enough without daily/weekly interruptions and interventions from Governmental and quasi-Governmental authorities (the Treasury Department/Federal Reserve), but when we introduce the constant interventions/interruptions, we are being asked to change our behavior as investors. Therein is the most problematic issue for investors these days, and what might explain the daily volatility of truly historic proportions that we have experienced of late.

Simply put, free markets are no longer free; rather, they are markets that have outside influences that seem random and deem our heretofore disciplines moot. Rather than whining, we must ask ourselves, how do we, as investors on our own behalf, or those working with other people's money, react to these outside influences?

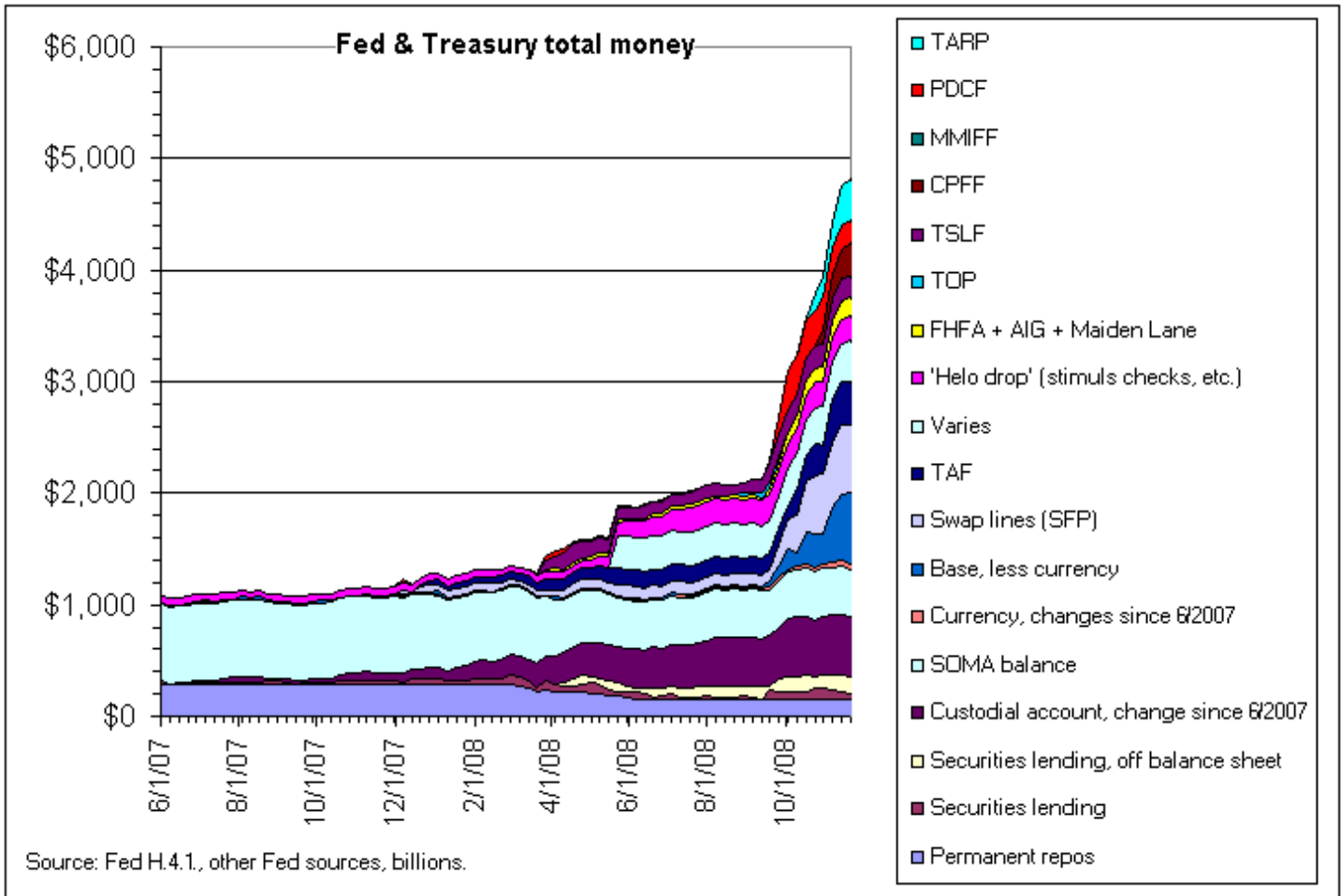
Interaction versus Intervention

Let's face it, most of us are used to free markets. In free markets, we are left alone to sort out the good from the bad, the value from the value traps, growth versus value, and so

on. Forgetting for a moment that while universities churn out loads of smart individuals, no one has been trained how to act

given the near random, high level of intervention.

Brother, Can you Spare a few Trillion?



Without regard to “which side of the aisle” you reside on, the truth of the matter is that we must, as those entrusted with Other People’s Money, make the *right* decision. To be completely honest, we feel like we can, and in fact, *have* performed admirably for our clients when the rules are, well, THE RULES!

Please allow me to put this concept in layman’s terms. We have all grown up with “three strikes, you’re out” rule. No matter if you were Mickey Mantle, Ty Cobb, Lou Gehrig, Stan Musial, or Roberto Clemente, you knew that you had exactly 3 strikes before you were *called out*. Baseball, with all of its multi-million

dollar contracts, at its core, lives by “Ball 4 and Strike 3”.

Why is it then, that no matter how all of us in the “performance” business suddenly have different rules? When I have a bad month/quarter/year (relative or absolute) I show my numbers. As much I would like to hide behind the bad ones (thankfully not too often), I show them anyway. But what if your weakest competitor was allowed to have 5 downs or 6 strikes, as opposed to the usual 4 downs and 3 strikes? Would you feel cheated? It would seem downright “un-American” and unfair, would it not? Of course you would feel

cheated because you would then believe that you too should have an extra down or strike or two. Talk about a poor precedent!

Why the Intervention Will End in Pain

For the better part of the past couple of years, I was looking for 750 S&P 500 as a target, and it is, in fact, where we went all in. As we neared 900, just a short week later, we sold, and retrenched to GNMA's.

Since that time, a short 10 days, we have had all sorts of new regulations and rules, so many in fact that I cannot keep track with the alphabet-soup that is now our economic reality.

The FDIC, was a woefully undercapitalized enterprise that was sure to be overwhelmed with defaults as its "troubled bank list" reached 117 names and nearly \$120 billion in assets. So what do we do? Enter the Treasury...**The Treasury basically acknowledged that fact that the FDIC was insolvent and not up to the task and announces the "TLGP" or Temporary Liquidity Guarantee Program, whereby banks, brokers and even "bank wanna-be's" borrow money in the 3% range. The TLGP, funded by, yes as always, "We the People" is suddenly backed by the full faith and credit of the U.S. Government.** In fact, as I type this, American Express Bank (yes they are a bank now) just filed a new deal with a price talk in the 3% range (see below):

AXP TGLP Announcement

Issuer: American Express Bank, FSB
Guarantor: The Federal Deposit Insurance Corporation (FDIC)
Guarantee: The debt is guaranteed under the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program ("TLGP") and is backed by the full faith and credit of the United States. The details of the FDIC guarantee are provided in the FDIC's regulations, 12 CFR Part 370, and filed at the FDIC's website, <http://www.fdic.gov/new/board/08B0Dtlgp.pdf>. The expiration

At the same time, on Friday you could buy 10 year senior notes (guaranteed by Amex, not the FDIC) 600 basis points over Treasuries and 2 year floating rate notes 800-900 basis points over LIBOR. So the free market is saying what it feels AXP paper is worth on its own while other investors flock to the FDIC backed paper. The problem as I see it is that unless the Treasury wants to back the entire credit market (likely turning Treasuries to junk status. No, I am not kidding), we are simply

delaying the inevitable failures that are to come. When we are losing 500,000 jobs per month, you can let these guys get our money at 3%, but it is not enough to stop the tide of foreclosures and defaults. In fact, a case could be made that once these programs run out, and once our treasuries, which have become one gigantic SIV (or like my friend Robert likes to say, "the big blob in the middle of the game"), the pain will eventually be felt.

AXP non-FDIC trades from Friday 12/5/08 (courtesy of Trade Web)

Ticker Actives Sectors										
View <input type="text"/> Cpn All Maturity 0 to Unlmt'd Size 500 to Unlmt'd										
ALL Auto Bnks/Bkr ConProd Dfnse Fin Health Ind Media Misc Oil/Gas Ret/Gr Tech Te										
Time	C/A	Ticker	Sec Des	EST/QT	Ref SPD	SPRD/Chg	ASW	ISprd	Bench	Price
12/05/08		AXP	AXP 8.150 03/19/38	3,500	516	-3	540.47	552.75	UST 30yr	99.2960
12/05/08		AXP	AXP 7.000 03/19/18	2,100	560	16	498.51	532.34	UST 10yr	92.4270
12/05/08		AXP	AXP 8.150 03/19/38	1,400	515	-5	541.18	552.74	UST 30yr	99.4720
12/05/08		AXP	AXP 7.300 08/20/13	2,254	626		516.81	531.87	UST 5yr	98.0410
12/05/08		AXP	AXP 2.04875 10/04/10	2,500	955				1M LIBOR	84.4970
12/05/08		AXP	AXP 2.83125 05/27/10	5MM+	874	-4			1M LIBOR	88.1250
12/05/08		AXP	AXP 2.83125 05/27/10	5MM+	903	25			1M LIBOR	87.7500
12/05/08		AXP	AXP 2.83125 05/27/10	5MM+	933	55			1M LIBOR	87.3750
12/05/08		AXP	AXP 7.300 08/20/13	665	639		525.24	542.87	UST 5yr	97.3750
12/04/08		AXP	AXP 2.83125 05/27/10	5,000	882				1M LIBOR	88.0000
12/04/08		AXP	AXP 8.150 03/19/38	2,500	519	-7	536.49	551.80	UST 30yr	98.5560

Summary—How do you “Play the Intervention Game?”

I asked a good friend of mine and former banker how he thought a prudent investor should invest in this market and I found his response fascinating—**“think like a regulator,”** he said. That it is the best answer I have heard yet, and one that I have heeded. With the short-term bailout of the automakers this morning, and the Government having been granted “oversight” for them, we take yet another step closer to Socialism. Talk about the blind leading the blind. The Government watching over the Big 3? Surely you jest!

At any rate, the only way to get through this environment is to never take your eye off of the “Big Picture”, but at the same time, know that regulators will do whatever it takes to keep the

system afloat, even as hundreds of thousands jobs are lost per month, and nearly 10 percent in all homes in America are either in foreclosure or have delinquent mortgages. This is why, when we do buy stocks for our clients, we will “rent/lease” them until we feel we reach investable levels - levels I still believe lie in the S&P 500 level yet another 40-50% lower. Again, if we are wrong, we will have lost opportunity, but not capital.

Bennet Sedacca

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