

HAMILTON ADVISORS

373 Stanwich Road
Greenwich, CT 06830 USA

Tel: 203-629-1112 Fax: 203-629-1469

Page 1 - These comments written on September 10, 2008

LEHMAN BROTHERS AND MARKET COMMENTARY

THIS AIN'T MY FIRST RODEO. IN RECENT WEEKS IT FEELS AS IF IT COULD BE.

This morning, September 10, 2008, Lehman Brothers made a call to once again reassure us that all is well. Well, maybe not well but OK enough to keep them going for awhile at least. The stock fell below 8 yesterday to a 10-year low – a drop of 45% for the day. (Today, September 17th, Lehman is 17 cents per share.)

Today Lehman has announced a \$3.9 billion loss for the quarter and has cut the dividend from 68 cents annually to five cents. We wonder why five cents instead of zero cents.

We think this is the end of Lehman Brothers as we have known it. Lehman Brothers was founded in 1844 in Montgomery, Alabama by Henry Lehman, an immigrant from Germany. Six years later his brothers, Emanuel and Mayer, joined him and they named the business Lehman Brothers. They were brokers who traded cotton, the cash crop of the time, and opened an office in New York in 1858. All of this occurred before and during the Civil War. After the War the brothers moved to New York and helped establish the Cotton Exchange.

Lehman was the firm I joined when I first came to Wall Street in 1960. Headquarters were on One William Street, and Lehman's sales force for the world was eighteen of us at that time.

Last night OPEC agreed to a 520,000 barrel per day cut in output below the official July output target of 28.8 million barrels per day. This meeting was in Vienna, the usual location, and the next is scheduled for December 17th in Algeria. With all their money we do not understand why they would change the venue from the luxury of Vienna to the sands of Algeria.

The Financial Crisis is far from over as on Monday, September 8th, the Government announced the bail-out of Freddie Mac and Fannie Mae, the largest in world history.

It is estimated that these two "companies" own or control between 60% to 70% of all U. S. mortgages. They had to be bailed out because of the enormity of the implications of their failure. Because their approximately \$6 trillion of debt, no one is sure how much this will cost the American taxpayer. Low estimates seem to be around \$300 billion, but we will have to wait and see.

At this time when the stock markets are impacted by enormous and irrational selling caused by forced liquidation of hedge fund positions and of other very highly leveraged investors, the thing to do is to have patience, hold on to shares of excellent companies and wait for the dust to settle. We will not be buying aggressively even with stocks at these levels until we can see

stabilization and some clarification of the extraordinary issues with which we and the rest of the world are dealing.

John W. Hamilton

THE GREAT UNRAVELING

September 17, 2008

After we wrote the above, Lehman Brothers declared bankruptcy on September 15th, the same morning the headlines across the front page of the *Wall Street Journal* were: Crisis on Wall Street as Lehman Totters, Merrill Seeks Buyer, AIG Hunts for Cash.

- As mentioned, Lehman did declare bankruptcy on the 15th. Its stock traded as high as 86 in February 2007 and now sells for 16 cents.
- Merrill Lynch was bought for stock on the same day by Bank of America. Merrill's stock sold as high as 98 in January 2007 and as low as 16.25 on September 16th.
- AIG (American International Group – reportedly the world's largest insurance company dealing in 130 countries) was bailed out by the Federal Reserve (our money) to the tune of an \$85 billion loan last night. AIG sold for 103 in January 2001 and now trades under 2. This was the third bail-out by the Federal Reserve after Bear Stearns and Fannie Mae and Freddie Mac – mentioned above. Hank Greenburg, AIG's founder and chairman until his being ousted 3 ½ years ago, reportedly lost over \$6 Billion in his AIG holdings last week alone.

We understand that in order to protect the interests of the US government and taxpayers the "AIG facility has a 24 month term. Interest will accrue on the outstanding balance at a rate of the month LIBOR plus

850 basis points." Further the Fed said: "the interests of taxpayers are protected by key terms of the loan. The loan is collateralized by all the assets of AIG and of its primary non-regulated subsidiaries.... The loan is expected to be repaid from the proceeds of the sale of the firm's assets. The US government will receive a 79.9% equity interest in AIG and has the right to veto the payment of dividends to common and preferred shareholders.

We do not exactly understand the 79.9% stock ownership instead of 80%, but apparently it has something to do with the Federal Reserve's not wanting its AIG holdings to show on its balance sheet.

In this morning's "Gartman Letter" the following is stated: "There are times when 'pragmatism must trump philosophy,' and the confusion and liquidation of the past week or so is one of those times." These comments were directed to those who "find this expansion of the Fed's powers bothersome at best and inordinately disconcerting at worse..."

The problem with AIG's insolvency, whose insurance operations are reportedly functioning very well, is that the company had issued over the last years some \$400 Billion of what we call toxic waste – derivatives, SIVs, other exotic financial instruments of virtually every type imaginable, and they did not have the liquidity to support their counter-party responsibilities in the event of problems with these instruments. Please accept this as a

gross over simplification, but it essentially is what all the “players” have been doing over the last number of years.

By rough count the Fed is backing J P Morgan Chase’s buyout of Bear Stearns by \$29 Billion. The exposure to the Federal Reserve (the American Taxpayer) as a result of its buyout of Fannie Mae and Freddie Mac could be in the area of \$300 Billion – nobody really has any idea. China alone has close to \$400 Billion of their bonds. And now the Fed has spent \$85 Billion rescuing AIG, the American International Group of insurance companies.

Sometimes we wonder how much money the U. S. Federal Reserve has or can come up with for the next emergency.

A few of the others playing in the same sandbox along with their all-time highs and approximate present prices are listed below. Please note these companies are not listed in order of importance and do not have identical problems. By no means is this a complete list of entities that own financial instruments of questionable or unascertainable value.

AIG	103	2
CITIGROUP	57	15
FANNIE MAE	89	0.45
FREDDIE MAC	74	0.26
GE	60	23
GOLDMAN SACHS	250	118
LEHMAN BROS	86	0.16
MERRILL LYNCH	98	20
MORGAN STANLEY	91	23
UBS	66	14
WACHOVIA	66	10
WASHINGTON MUTUAL	46	2

At this time we would again invite you to visit our Web site: www.HamiltonAdvisors.com and would like to share with you the Commentary we wrote just over a year ago on August 28, 2007 titled “The Chickens are Coming!” After all, Past is Prologue, and we think that a look back to what was happening a year ago and well

before that along with our rather outspoken thoughts could be of interest in these times of Crisis in the Financial Markets.

Our hindsight was foresight, and we made our investment decisions accordingly. We have not, to the best of my recollection, taken any significant positions in companies primarily involved in the financial markets well before or since then.

THE CHICKENS ARE COMING! THE CHICKENS ARE COMING!

August 28, 2007

“The world, one had to remember, was analog, not digital, in the way it operated. And ‘analog’ actually meant ‘sloppy.’” The Teeth of the Tiger, by Tom Clancy.

We wrote that last month (please visit our Web site www.HamiltonAdvisors.com) and will include it again this month as “sloppy” cannot begin to describe what we have seen lately in the stock and bond markets.

Remember the old adage that the only three things you had to know about real estate were Location, Location, Location! Now you have to add Credit, Credit, Credit and more Credit! And Leverage in many cases involving billions of dollars.

The markets have been extraordinarily sloppy, and frightening, because of U.S. and Global credit policies over the last five years and because the Financial Geniuses have been able to spread the risk from this country to the entire world. And the entire world has bought into it hook, line and sinker!

The banks and Wall Street have developed, and more importantly sold, to the buyer and the seller, mortgages that have at times equaled 100% of properties’ market values at the time they were issued. Often those mortgages did not even require the

buyer to include more than his or her name, presumably their real name, although in the end that really wouldn't make much difference. These were called "No-documentation" or "no-doc" loans. Billions of dollars worth of these mortgages were also sold, where one could not only buy the property at 100% of stated or sometimes overstated value, but also with interest-only payments.

Or, one could buy a 30-year mortgage and pay interest only for two years and then enter into a more conventional financing arrangement at a very high interest rate for the remaining 28 years. These were known as 2/28s and were the rage in 2005 and 2006, particularly at a time when house prices were skyrocketing and interest rates on mortgages were at their lowest in memory if not in history. Subprime loans rose to more than \$600 Billion in 2005 and 2006 versus \$160 Billion in 2001 when they were primarily used for home-equity loans. Later homes were used as ATMs and offered many of the biggest and "best" bets imaginable.

It was a Win-Win situation for everyone --- the house buyer and seller, the real estate agent, the insurance broker, the mortgage broker, the lawyers and the first-time lender, usually a bank. As the business grew, the loans were "packaged" or "securitized" and sliced into tranches where the poorest credits ("junk") were at the bottom of the pyramid while the highest quality credits (AAA) were at the peak. The ratings agencies often assigned their highest ratings to the entire pyramid.

It is important to understand that this process effectively transferred the risk of owning a mortgage, or a package of mortgages, from the first lender – the bank – to the ultimate mortgage holder – the investor. The investor often does not have a second-party against whom he could make a claim in the event of a default. The investor, as mentioned above, could be anywhere in the world during these halcyon days and could be a hedge-fund, an endowment, a retirement system or pension fund, et cetera, et cetera.

Nobody really knows who or where all the investors are, let alone how much money has been invested in subprime mortgages. What is known is that the amount of money involved is beyond a mere mortal's comprehension. Further, the investor did not and still does not, in the overwhelming number of cases, know or is able to find out the "real value" of his "asset." Furthermore, the investor in the subprime mortgages no longer had the Fed or deposit insurance to fall back on as before.

Who could have been so naive as to think of a world where house prices would plummet and mortgage and interest rates in general would rise? It was supposed to continue to be just the opposite.

But contrary to conventional wisdom the worm turned, and housing prices have been plummeting while interest rates have been rising. For example: If one bought a home for \$100,000 and paid nothing down and "interest only," what would one expect to happen when that buyer can or will no longer pay the interest only, or pay the higher interest due when the mortgage resets (meaning a higher interest must be paid by the home owner on his interest only, 2/28 mortgage or ARM – Adjustable Rate Mortgage)? The lender paid \$100,000 in the beginning, but the house is now worth, say, \$70,000 more or less.

The homeowner decides he cannot or will not pay the mortgage or interest on his home where he owes \$100,000 on a property that is worth only 70% of that. What happens when that owner sticks his key in the front door and walks away? The bank or lender takes over a loan investment that now carries a \$30,000 realized loss. Multiply this situation by an estimated 7,000,000 times in the coming months, and you can see how some people can become upset – like right now! What is happening today is that the lenders, in many cases, are trying to "unwind" or sell their securitized mortgage packages where they have in many cases leveraged themselves by borrowing 7, 8, 9 or 20 times the amount of

their cash investment in order to purchase those high interest bearing mortgages.

The most dreaded words in the investment business are NO BID, and that is what is happening now. Potential buyers have either said NO BID, having no interest in buying the mortgages or other assets, or they are offering very low prices that if a transaction occurred at that level would in turn necessitate the hedge-fund's or other investors' possibly having to mark down – devalue –their entire investment portfolio.

These investments in many cases had previously been marked to the investor's "model" – often their cost - rather than marked to the "market." But that is a different subject for a different day as it brings up the extraordinarily important question of how valid the previous performance records of many "investors" have been since the "real value" of the investors' assets could have been worth far less than the value stated in their "models." The validity of performance results in recent years is brought into question. And the conflict is that the money managers, for the most part and to a very large degree, get paid on their performance. We will soon get more evidence as to how much recent years' performance results have been overstated. The degree of accuracy of reported performance results will be the subject of the SEC's and other federal and state agencies' investigations as the story unfolds, and the truth becomes clear.

LOW RATES, A WORLD AWASH IN MONEY AND MORE CREDIT

The U.S. Federal Reserve bank lowered the federal-funds rate to just 1% in June 2003 and kept it there for more than a year. The idea, as told to the public, was to avoid deflation.

Mr. Greenspan said in August 2005, six months before retiring: "History has not dealt kindly with the aftermath of protracted

periods of low risk premiums." But what the Fed, i.e. Mr. Greenspan and Mr. Bernanke, did not foresee was the deluge of capital pouring into the U.S. from overseas. The effect was to keep our banking system awash with capital. Interest rates remained low, at least lower than they should have been, in our opinion. Mr. Bernanke has referred to foreigners putting their reserves into U.S. Treasury obligations a "global savings glut." The Drudge Report as recently as July 20th stated: "Foreigners put more money into American stocks and bonds in May than in any previous month in history."

WE WROTE TO OUR CLIENTS ON JUNE 10th WHEN THE MARKETS WERE HITTING NEW HIGHS:

"Risk still exists although it is not mentioned in polite company and certainly not on TV.

"In other words, it has taken seven years and two months for many of the averages to get back to where they were in the halcyon "dotcom" days --- the craze that exploded in March 2000. Not surprisingly, there are now a number of other excesses that are sources for legitimate concern.

"The U. S. economy seems to be coming in for the much desired "soft landing" and global money supply is at a level never seen before. However, continuing problems in housing and with the extraordinary financial leverage used globally by Hedge Funds and Private Equity groups could scuttle today's market euphoria."

And we have not even mentioned the Leveraged Buy-Out Crowd and Private Equity folks out there who may have to be funding up to \$500 billion under these conditions to complete their previously announced deals. There are many on that very large hook for \$500 billion.

Again we would like you to note the following relevant comments from the *Financial Times*.

On November 7, 2006, the *Financial Times* carried an article titled “Big buy-out collapse ‘inevitable.’” “The collapse of a large buy-out is ‘inevitable’ and could ultimately pose a threat to the stability of the UK economy, Britain’s main financial watchdog warned yesterday as it became the latest national regulator to turn its attention to the private equity industry.” “The US justice department also recently launched an inquiry into potential anti-competitive behaviour among US buy-out houses.” There is currently a short-term approach and speculation in the financial sector in general that is bad for the economy. It must become more sensible. When you see groups buying one company after another and then another, you start to ask questions....” “The default of a large private equity-backed company is increasingly inevitable....” “Such defaults would have negative implications for lenders, purchases of the debt, orderly markets and conceivably, in extreme circumstances, financial stability and elements of the UK economy.”

The results of a financial blow-up – or melt-down - will affect the US markets and ultimately the economy, just the same as in the UK and elsewhere in today’s Global Economy. In other words, each of us would be negatively and seriously affected.

Also note from the *Financial Times* on May 3, 2007 an article titled “NY Fed warns on hedge fund risk.” The first sentence began: “The risk hedge funds pose to the global financial system has reached levels by some measures comparable to those just before the Long Term Capital Management fund imploded in 1998, the Federal Reserve Bank of New York said yesterday.” “The bank’s study is the latest contribution to a debate that has seen regulators and analysts express concern over the risks and leverage taken on by hedge funds, the private investment vehicles that are increasingly influential in financial markets. The hedge fund industry has mushroomed in recent years and now accounts for an estimated \$1,500bn (\$1.5 trillion to us Americans) of investments.”

The following is a quotation from “Et Tu, Paribas? (Review & Outlook) on the Opinion page of the August 10th Wall Street Journal:

“What’s becoming clearer by the day is that we’re watching the unraveling of a global real estate financing bubble. The U.S. subprime market is the heart of the problem, but financial innovation has spread the risk around the world in a way that wasn’t possible a generation ago. Long-term assets – real estate – have been financed by hedge funds with short-term debt instruments, and the amount of the debt now exceeds the value of the collateral in these subprime investments. Somebody is going to have to swallow the difference....”

We will be the first to admit that we are unable to call market highs or bottoms. Imagine the markets to be like a pendulum that when at rest its “real” or “true” fixed point (or value in this case) is at 6 o’clock. Bull markets always overshoot to the upside, for example to 9 or 10 o’clock and bear markets to the downside, for example to 3 or 2 o’clock.

We repeat we are not in the “gloom and doom” business --- just the opposite. Nevertheless, the above articles and comments are from eminently respectable sources that we take very seriously in view of our experiences having spent careers in the investment business in excess of 110 years. It is part of the struggle to Preserve Capital as well as to make money, and we have learned over those years that one of the best ways to “make money” is to keep from losing it.

The tip of the Iceberg: If what has happened to Bear Stearns (two hedge-funds holding more than \$20 billion of assets just several weeks ago requiring \$1.6 billion – the numbers are still vague), Goldman Sachs (its Global Equity Opportunities Fund needing a \$3 billion cash infusion after a 30 percent loss of its value last week and its flagship formerly \$10 billion Global Alpha fund down 27% for the year as of last Friday, June 10th) and KKR, can such problems crop up anywhere

else or with different forms of financial instruments? Take a guess. And keep in mind, while these players are not exactly warm and cuddly, they probably have had the most experience working with many of the “smartest” people inhabiting these non-eleemosynary intuitions.

The problem is years of unwise credit expansion and unwise use of leverage with the result that the Chickens are now Coming Home to Roost. The Trillion dollar question is how many Chickens are coming home and how long they will be staying!

John W. Hamilton

August 28, 2007

Email: jwh@hamiltonadvisors.com

Web site: www.hamiltonadvisors.com

PRIVATE WEALTH MANAGEMENT SINCE 1980

This publication contains the current opinions of the author and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. The distribution of this publication is for educational purposes only. Information contained herein has been obtained from sources believed reliable, but not guaranteed. © 2008 Hamilton Advisors, Inc., 373 Stanwich Road, Greenwich, CT 06830. All rights reserved. Tel: 203 629 1112. Fax: 203 629 1469

