



## Investing Environment for the Period Ended September 30, 2008



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*"Tis true that we are in great danger.  
The greater therefore should our courage be."*

— Henry V  
Shakespeare

*Author's Note: Common courtesy suggests that religion and politics are two subjects to be avoided in polite company. Avoiding religion in a letter that purports to discuss the world of investing is easy, avoiding politics is more difficult. Accordingly, every four years I write an essay on the intersection of politics and investing. The perspective of this essay is that of an investor, not a Democrat or Republican. As such, our friends on the left and the right of the political spectrum will likely find themselves in agreement with parts of this letter and disagreement with other parts. That's okay; this letter should be viewed as an invitation to a conversation rather than the last word.*

An online survey<sup>1</sup> of Shakespeare fans ranked *Hamlet*, *Othello*, *Macbeth*, *Romeo and Juliet* and *The Tempest*, as the most popular Shakespearean plays. Predictably I suppose, I find myself not in agreement with the crowd. *Henry V* is my favorite Shakespearean play.

Although there are multiple themes in *Henry V*, one of the most powerful themes is political leadership during very difficult times. The play is set during the Hundred Years War (1337-1453) and climaxes with the famous Battle of Agincourt. At Agincourt, the British, outnumbered by an estimated five to one, crushed the French forces. During the course of the play *Henry V* displays multiple styles of leadership depending on the circumstance and matures from a party boy to an inspirational leader who rallies his troops to a great victory on the battlefield and, as the play concludes, marries Catherine, daughter of the French king, and seals the peace. The verdict is that *Henry V* displayed great courage at a time of significant danger. The verdict of the American people, judging by the rock bottom approval ratings of the President and Congress, is that political leadership is in short supply these days.

In this political season, it is difficult not to get caught up in the daily tit-for-tat political rhetoric. The argument here is that one can largely ignore such rhetoric. Why? If history offers any counsel, events will conspire to make such rhetoric a distant memory. Who would have thought that a self-styled conservative such as George W. Bush would preside over one of the biggest expansions of federal government power since Franklin D. Roosevelt. One can debate whether such measures as increased surveillance over citizens in the name of fighting terror, Medicare Plan D, and finally the socialization of major parts of our financial infrastructure were justified. That is not the point. The point is that the future is highly uncertain and events will force the hand of our political leadership.

Let us turn now to the issues of great importance to investors<sup>2</sup> that over the next eight years are likely to require our political leadership to act, possibly in ways that directly contradict their political rhetoric during the campaign. There are several problems that must be addressed in order for the

United States to retain its position as the world's preeminent economic and political power. Left unaddressed, America risks a slow slide into reduced stature. If you believe that I am being melodramatic, consider that the timing of the seizure of Fannie Mae and Freddie Mac was dictated not by domestic policy considerations but by our creditors overseas. In effect, the U.S. lost a measure of its sovereignty at that moment. We Americans had better get used to that experience unless we address our problems with the courage of *Henry V*.

As investors, we have vital stakes in several of America's problems:

### 1. *Recreating our Financial Markets.*

Paul Volcker has rightly declared that our financial system is broken. As this is written the nation's, indeed much of the world's money markets, are barely functioning. Longer term credit markets are virtually frozen for all but the most credit-worthy borrowers. The reasons for this stem from the unwinding of a vast credit boom that has been described in previous Investing Environment letters available at our Web site, *FortWashington.com*. In past letters, we have suggested that demographics were an important causal factor in the leverage boom. We have not explored another important causal factor: the loosening of capital requirements for the five largest investment banks in an April, 2004 SEC ruling. In the following years, the leverage ratios of Wall Street rose dramatically. Prior to its collapse, Bear Stearns had \$33 of debt for every \$1 of equity. History is likely to judge the decision made by the SEC in April, 2004 harshly. The cautionary note from this episode is that as attempts are made to refashion the industry, the ramifications can be enormous. While the problem of the financial markets presently was caused by unwise deregulation, there is great risk if the pendulum swings too far back toward reregulation. Remember the outrage that the investor class felt over the Enron, WorldCom et al in accounting? "*Do something!*" we cried to our leaders. The "*something*" was Sarbanes-Oxley (2002), which has put a damper on IPO activity ever since and is viewed by many members of the investor class, including yours truly, as a failed policy. We as investors are now dealing with the effects of two failed government actions, one aimed at deregulation, the other at reregulation. Here's hoping that the next Administration and Congress will be wise in putting in place a regulatory framework for financial services that will strike an appropriate balance between the need to encourage the risk taking that built America while controlling the worst excesses. As Aristotle taught us "*All things in moderation.*"

### 2. *Energy*

One could argue that the nation's financial crisis developed rather quickly in the wake of the SEC's disastrous 2004 ruling on Wall Street leverage and that the political and investor classes had little time to appreciate the gravity of the situation as it unfolded. No such excuse can be made for our energy woes. This is our

<sup>1</sup>Source: [www.william-shakespeare.info](http://www.william-shakespeare.info)

<sup>2</sup>Issues involving foreign policy will not be addressed in this letter, as they are, to use Barack Obama's phrase "*above my pay grade.*" However, issues of war and peace are also of great importance to investors.

third energy crisis in my lifetime. How many warnings do we need? I thought it would be fun to catalogue some of the factors that got us into this mess:

- Limited areas for offshore drilling
- Moved very slowly to raise CAFE<sup>3</sup> standards
- Restricted nuclear energy development
- Weak dollar policy
- Lack of meaningful energy conservation initiatives
- War in Iraq and geopolitical instability, in general
- Limited subsidies for hybrid cars
- Suburban sprawl
- Etc.

Recently commodity prices have declined somewhat and our fear is that such declines will push energy reform to the back of the queue of policies up for debate. This would be a grave mistake. The price of oil is down because of demand destruction brought about by economic weakness, rather by the discovery of new supplies. Indeed, we believe that one of the surprises of the next five years will be the rate of fall-off in the production levels of important fields such as Ghawar in Saudi Arabia. We believe the next Administration and Congress will need to make tough decisions that risk offending their political base to manage future energy supply and consumption. The rise in energy demand from China and India will be unrelenting and will create a global imperative to manage our resources wisely.

We need a radical change in the vehicle efficiency of the U.S. automobile fleet. As a bridge to a retooled U.S. fleet, we need expanded utilization of remaining U.S. energy resources including Alaska, the various shales, and offshore drilling under strict environmental controls.

Finally, we need full scale development of alternative energy in various forms. History counsels that technology will solve our problems, if we let it do so. One factor holding back development of alternative energy technologies is uncertainty over the future price of oil. Technologies that make sense at \$60/barrel oil may be uneconomic at \$40/barrel. The best idea that I have seen to deal with this is to put a tax on the price of oil if it falls below a certain level, say \$60/barrel. If the market price is \$65, there would be zero tax but if the price fell to \$55/barrel a \$5 tax would kick in and maintain the price at \$60. This would remove the uncertainty that venture capitalists and entrepreneurs face and would likely unleash a wave of innovation.

We simply must address our energy issues; China and India are on the rise, major oil fields around the world are maturing or declining, new fields are difficult to find and often in inhospitable locations. Once again, the courage of Henry V is called for as politicians will be called on to make decisions that offend the base but are vital for the commonweal.

<sup>3</sup>Corporate Average Fuel Economy (CAFE)

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### 3. *Rebuilding the Social Contract*

The term "social contract" refers to a broad class of theories that center around agreements between people by which their moral and political obligations are defined and a society is built. Social contracts vary by culture. At the risk of over-generalizing, Europeans have a more collectivist culture than the Americans with our individualistic and pluralistic culture. The European culture is broadly supportive of nationalized, single payer health insurance, for example.

America's recent social contract reads something like this: work hard in school, go to work for a good company that provides a fulfilling career and a broad safety net of health and life insurance, and retire comfortably with a defined benefit pension supplemented by Social Security and health care provided by Medicare.

When framed in this manner, it is clear that the American social contract is fraying badly. Our schools continue to slip. Job security is low for many people and workers find it risky to chase opportunities because they can't bring their health insurance with them. The defined benefit pension program is being rapidly replaced with defined contribution which leaves workers to assume a role for which they are manifestly unqualified: money manager and asset allocator. Then, there is Social Security and Medicare, which face major solvency crises in the years to come. Americans understand this. Polls suggest that large majorities of Americans believe the country is on the "wrong track."

Recently, the "bailout" bill for Wall Street generated huge expressions of anger by our fellow citizens. Both McCain and Obama are fashioning their campaigns around the concept of "change." But change to what? Implicitly, the change is to a new social contract because the old social contract is collapsing. No one knows what the new social contract will entail. But a new one must be crafted as we Americans rewrite the rules that govern our interactions in a way that is reflective of our culture of individualism but mindful of our need to provide a stable environment to raise the next generation. Good luck to us all.

There are other issues that America will need to address in the years to come. I have highlighted the three issues that I believe are of the utmost importance to the investor class, which includes many Americans by virtue of their 401(k) plans. As we Americans go to the polls let us hope that our collective wisdom leads us down a wise path, whatever that might be. Once elected we pray that our politician display great wisdom and courage for like Henry V, tis true we are in great danger.

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