



## Investing Environment for the Period Ended December 31, 2007



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*"I tell them that I'm doing fine watching shadows on the wall."*

— John Lennon  
Watching the Wheels

*"Give me a lever long enough and a fulcrum on which to place it and I shall move the world."*

— Archimedes  
Greek Scientist  
287 BC-212 BC

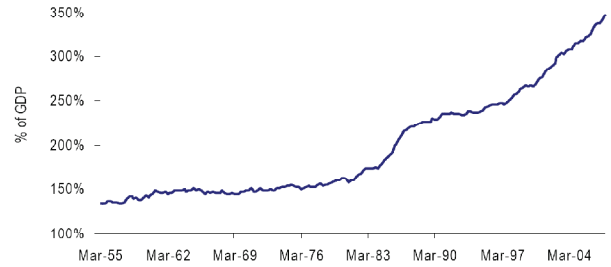
The literary reference in John Lennon's song is to Plato's famous Allegory of the Cave in *The Republic*. In a nutshell, the Allegory of the Cave is a story about prisoners chained in a cave only able to look forward at a wall. Behind the prisoners burns a fire which casts shadows on the wall of the activity occurring between the fire and the prisoners. Eventually the prisoners begin to mistake the shadows on the wall for reality. Plato's point is sense experiences, in the form of appearances in this case, must be treated with profound skepticism given the difficulty we all have of discerning ultimate reality.

A similar skepticism is entirely appropriate when contemplating the current crisis in the financial market. The situation we find ourselves in is extremely complicated and changing daily. Who would have dreamed that Bear Stearns (ticker: BSC) could close at \$57.00 per share on March 13th, \$30.00 per share the next day, a Friday, and then be taken over in a shotgun wedding situation over the weekend for a mere \$2.00 per share? In the process, \$6.2 billion of market capitalization of Bear Stearns was vaporized in two days! Bear Stearns, it should be noted, was founded in 1923 and is one of the Big Five New York based investment banks. The \$2.00 was later amended to \$10.00 per share but the point remains that this crisis is volatile and unpredictable.

If there was any doubt about the volatility and unpredictability of the current situation, the Bear Stearns debacle has shown that we are all like the prisoners in the cave. Recognizing the difficulties and limitations of our ability to grasp this situation, however, does not absolve us from the need to frame this crisis in a way that allows us to make rational investment decisions.

The thesis in this paper is that we have reached the end of a great Debt Super Cycle. First let's look at the facts, courtesy of Bear Stearns, ironically.

### Total U.S. debt as % of GDP (last observed: 4Q 2007)



Source: Haver, Bear, Stearns & Co., Inc.

Declaring the end of a trend that has been in place for decades is fraught with risk at best and a fool's errand at worst. Debt as a percent of GDP has grown through good times and bad, booms and busts. A careful reading of the chart suggests that there have been periods in which the ratio was relatively flat. Even still, calling a "top" to such a long term trend seems foolhardy. What could possibly give one reason to make such a call? One word: Demographics. But more about that later.

The ratio of debt to GDP tells a story, but not a complete story, because what matters is the ability to service the debt. The Federal Reserve has various ways to measure household debt servicing capability. Any way you look at it, however, debt is at record levels. The ratio of debt to income is at the highest level ever and has risen dramatically in the last six years. Similarly, Federal Reserve data shows that the Debt Service Ratio and Household Financial Obligation ratio are at record highs. The definitions of such ratios are technical and not particularly important; they all tell the same story - that the consumer is stretched thin financially.

The economist Herbert Stein once pithily observed, "If something can't go on forever, it will stop." We think that the pace of debt formation in this country is something that cannot go on forever. The leading edge of the baby boom generation, those born between 1946-1964, is closing in on retirement. Yet boomers have a history of saving very little. The Personal

**"Why save, the quintessential baby boomer thought, when I have technology stocks and my house to provide for my retirement?"**

Savings Rate, as measured by the Bureau of Economic Analysis, shows that savings as a percentage of income have declined from over 10% in the mid 1980s to near zero today.

If we are correct that the debt super-cycle is coming to an end, then profound investing implications are likely. To start with the most obvious effect, companies whose fortunes are tied to discretionary consumer spending are likely to face a multi-year period of difficulty. Among those businesses that spring to mind include furniture, appliances, home improvement, autos, restaurants, apparel manufacturers and retailers, cruise lines and many others. To support the spending boom of the last two decades a great deal of capital has been spent building capacity in various forms ranging from factories (many now in China) to retail stores. Some of that capacity will need to be "rationalized" which is a polite way of saying that there will be messy bankruptcies (see Sharper Image, Lillian Vernon, Linens 'N' Things, and Wickes among others as the front end of this phenomenon).

What about less obvious manifestations of deleveraging? Just as America is "over-stored," it is also "over-banked," a catch-all term for overexpansion of capacity in financial services. The creation of all that debt required tremendous infrastructure ranging from the bottom of the food chain (mortgage brokers, bank branches, even insurance agents) to the top of the food chain (Wall Street with its CDOs, CLOs, leveraged loans and the like).

In addition to physical infrastructure, there is also balance sheet leverage that has added to capacity. Over the last 15 years, banks have increased the leverage of their tangible capital by two full turns to approximately 15.5x. But that is nothing compared to Wall Street investment banks whose leverage ranges from 22-32x capital.

The thesis is that the financial services industry will have to work its way through a protracted period of rationalizing excess capacity. This process may not be pretty. When Sharper Image goes bankrupt, the world barely notices, when Bear Stearns nearly goes bankrupt, the world shakes, proving that Wall Street has found the lever and fulcrum of which Archimedes spoke. Undoubtedly there will be failures. The FDIC is calling back former employees from retirement (one way to deal with a retirement savings issue is to go back to work!) to prepare for failures. It is possible that Wall Street employment will be cut dramatically. The nation's ranks of mortgage brokers, real estate agents, appraisers and the like are sure to thin, as well. Capital, while scarce now, may prove to be in great abundance for many financial companies in the future as quality lending opportunities become harder to find. Consolidation among financial companies will reaccelerate once buyers and sellers have confidence in each others' balance sheets.

The peak of the debt super-cycle will likely have a profound impact on the consumer discretionary and financial sectors. But other sectors will probably be affected—as well. Consider technology. There are important segments of technology, including venture capital, that are meaningfully exposed to the consumer ecosystem and, for that matter, to small businesses whose founders often have a fluid separation between business and personal affairs. The handset vertical seems vulnerable to consumer cutbacks. Then there is the mega-sector of global cyclicals (i.e. energy, materials and capital goods) where performance has been strong. Even in this unlikely setting,

financial issues loom. Many manufacturers have gotten into the finance business as a way to decrease customer perceptions about acquisition cost.

The implication is that if the U.S. consumer slows down spending and the savings rate rises materially from zero, the ramifications will be widespread in both the public and private equity markets.

The private equity side effects are likely to mirror those in the public market. In technology-oriented venture capital, we may find that winners in consumer-related companies are harder to find and venture backed companies selling into corporations experience a revival after taking a back seat to consumer-related companies for the past several years. Health care venture capital should be a relative safe haven. On the buyout side in the near term, opportunities for top notch distressed firms should be abundant. Sector-oriented funds focused on the consumer are likely to face some difficult situations in their portfolio. Infrastructure and energy funds seem like relative safe havens. Finally, what about the mega buyout funds such as KKR, Carlyle, TPG and others? These firms are likely to experience some problems in their existing portfolios as many of them were quite aggressive at the peak. Moreover, the mega firms will find it difficult to do much buying as long as financing markets stay in lock-down mode. Over the long term, however, if the thesis of this paper is correct, the large buyout shops may find lenders anxious to serve them as other lending opportunities become scarce, at least relative to the capital chasing such opportunities.

Will all of this come to pass? We'll see. Amidst all the uncertainties of the investing world, however, demographics are one of the few things that can be known with near certainty. Retirement looms for baby boomers. Technology stocks and real estate have proven to be unreliable as retirement funding vehicles. Baby boomers will need to start saving and that's not just a shadow on the wall.

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