



## Investing Environment for the Period Ended March 31, 2008



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*"There is no present or future, only the past happening over and over again."*

— Eugene O'Neill  
Irish Playwright  
1888-1953

*"Are we there yet?"*

— Everyone's child on  
a long car trip.

Eugene O'Neill won the Nobel Prize in literature in 1936. His famous quote which opens this essay refers to Ireland's 800 year struggle for freedom, not the regular recurrence of financial crises that roil markets. Still, the quote seems strikingly apropos for our present situation in the markets. Credit crises are not new. By my count, the current crisis is the tenth important crisis since my investing career began in 1979. Moreover, by virtue of my first job being a bank analyst, I feel I have had a front row seat for these crises. The chart below<sup>1</sup> maps the crises and the concurrent progression of the Dow Jones Industrial Average.



The initial message of the chart is a reassuring one; if history provides reliable counsel, the system will survive. More sobering is the virtual certainty that once the current crisis is in the rearview mirror, another crisis lies ahead. Indeed, the pattern of lurching from crisis to crisis in the financial world seems endemic to the system. The reason lies in leverage. It is easy to forget that a financial institution might lever its equity 15-20x. Several Wall Street firms had leverage of over 30x at the peak. Accordingly, it does not take a great deal of volatility on the asset side to severely stress the thin layer of equity. Still, the system survives, even if severe doses of pain are meted out to miscreants.

The question financial markets struggle to properly discount is how close we are to the bottom of this crisis. Every parent that has ever taken a young child on an extended car trip has heard the words "Are we there yet?" Investors today are asking the same question. Implicit in that question is the understanding that the financial markets will begin to move higher in advance of a turn in fundamentals showing up on the front pages of the daily newspapers.

The argument here is that we are well down the path toward healing the financial system. Importantly, however, the stocks of credit sensitive groups such as banks, Wall Street brokers, and homebuilders are not showing signs of bottoming, so the reasonable conclusion must be that we are not fully "there" yet. That said, consider the steps toward healing that have occurred and are on-going:

### 1. Ensuring liquidity is available to financial institutions

A bank run is a frightening thing. Remember Jimmy Stewart in the perennial Christmas favorite *It's a Wonderful Life*? To prevent such a scenario, the Federal Reserve was created to provide liquidity in times of stress and FDIC deposit insurance was created to ensure times of stress were few and far between. Until the current crisis, however, Wall Street firms did not have access to the Fed window, as it is called. Moreover, only certain types of collateral, mostly Treasury securities, were heretofore acceptable for Fed window borrowing. In response to the current crisis, which was brought to a head on the weekend of Bear Stearns' "run on the bank", the Fed modified its program by opening up its window to Wall Street and accepting non traditional forms of collateral. These program modifications seem to have been effective although constant vigilance in this area is required. The image from the U. K. of Northern Rock Bank depositors stretched around the block waiting to withdraw funds last year must haunt central bankers worldwide.

### 2. Rebuilding the capital of financial institutions

Institutions ranging in size from Citigroup to small community banks have tapped the capital markets for equity to rebuild their balance sheets. The aggregate capital raised seems to increase daily but currently exceeds \$310B.<sup>2</sup>

### 3. Retaining earnings

Financial institutions can also rebuild capital by greater retained earnings. Over the next few quarters we are hopeful that core profitability will improve by virtue of the steeper yield curve. In addition, capital grows when dividends are cut. Here again, we have seen dividend cuts by financial institutions of all sizes.

<sup>1</sup>Source: FT Ventures

<sup>2</sup>Source: Bloomberg

#### 4. Moving weak financial institutions into stronger hands

Consolidation is an inevitable consequence of financial crises. In the midst of the crisis the weakest firms, in this case Bear Stearns and Countrywide, found themselves in shotgun wedding situations. Once the clouds begin to clear, an important wave of industry consolidation seems inevitable.

#### 5. Finding market clearing prices for troubled assets

First and foremost, the inventory of homes must begin to clear. Transaction volume has been very slow indicating that buyers and sellers have not completed what economists delicately refer to as "price discovery." The worst of the housing market debacle has occurred in once-hot real estate markets such as Miami, Phoenix, Las Vegas and parts of California. The issue in many once-hot markets is one of affordability. The National Association of Home Builders publishes the Opportunity Index, defined as the share of homes sold that is affordable to a family earning the local median income. By this measure housing affordability is approaching the 2003 level, the point at which underwriting standards started becoming lax thereby kicking off the boom/bust cycle. There is, however, a long way to go before reaching the 1993 peak of affordability, not to suggest that such a peak will be revisited. In short, affordability is one important precondition for a housing recovery, which is itself a precondition for financial market recovery that seems to be falling into place.

An important question is the role that private equity may play in the healing of the financial system. With several notable exceptions, private equity has not played a large role in regulated financial institutions, though it has been very involved in financial services writ large in areas such as payment processing, money transfer and the like. There are good reasons why private equity has historically had limited involvement with regulated institutions. The reasons center around two concerns:

#### 1. Control

As part of a longstanding policy of separating banking and commerce, non banking firms are generally prohibited from owning more than 25% of the voting stock of a bank. If the commercial firm wishes to have a director on the board, the permissible stake is generally less than 10%. These provisions are highly problematic for private equity because control is such a central part of the investment model. The ability to exert control is, in a sense, the quid pro quo for the illiquidity of a private equity investment.

#### 2. Potentially Unlimited Liability

If a commercial entity owns more than 25% of a bank, the entity must register as a bank holding company. This means it can be forced to serve as a "source of strength" for the bank—lawyer-speak for unlimited liability, obviously an unappealing prospect.

Some lawyers argue that such provisions are subject to interpretation. Others argue that these provisions can be amended by administrative intervention. We're not sure how this will play out. Given the alternative in many cases is a taxpayer financial rescue, it is entirely possible that some of the barriers to private equity becoming involved with regulated financial institutions will fall. Time will tell.

Where does this leave us? Clearly, there are too many unknowns to say for sure. The latest spike in oil prices has worsened an already unpleasant state of affairs. This crisis has had a significant human cost. The unemployment rate is up and Consumer Confidence is at levels not seen for several decades. As always, the poor suffer the most. But a great deal has been accomplished since the latest crisis bloomed last summer. Most importantly, the liquidity aspect of the crisis seems, fingers crossed, to be behind us. The solvency aspect of the crisis is a work in progress. Stay tuned and watch the market signals sent by the stocks of credit sensitive companies for signs of a bottom. For those who can invest capital in the general vicinity of the bottom, generous returns will follow.



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