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THIS ISSUE...

Does Size Matter?

by Michael H. Palmer, CFP®

Editors Note: All of the articles in this edition of The Compass were written in mid-September; however, the financial markets have been fluid since that time. More to come in our next edition.

I am a fan of the 1990's hit sitcom *Seinfeld*. Some of the recent events in the financial services industry have parallels to a particularly funny Seinfeld episode. In it George Costanza attempts a ruse in order to continue collecting unemployment benefits. He tells his case worker that he's interviewed with Vandalay Industries for a job as a latex salesman and gives his friend Jerry's home phone number as the number of the company. He then brings Jerry into his web of deceit and forces him to answer his phone "Vandalay Industries." The caper comes undone when Jerry's neighbor, Kramer, answers his phone, clueless to the ruse. "No, you're way off," he tells the case worker when she calls asking for Vandalay Industries, while George stumbles from the restroom half-dressed in an attempt to beat Kramer to the phone. Jerry walks into his apartment to find George lying half-naked on the floor of his apartment to which he quips, "And you want to be my latex salesman?"

I found it oddly reminiscent of the problems facing some of the largest names in the financial services industry. UBS, Merrill Lynch, Smith Barney parent Citigroup, and Wachovia, all firms that promote their financial acumen at helping investors successfully manage their capital have had a difficult time managing their own of late. The chart below details the capital destruction.

	Market Cap 6/30/07	Market Cap 6/30/08
UBS	$130 Billion	$41 Billion
Merrill	$71 Billion	$31 Billion
Citigroup	$255 Billion	$87 Billion
Wachovia	$97 Billion	$33 Billion

In one year's time these firms have managed to lose a collective $361 *billion* in shareholder value. As the late Senator Everett Dierksen once quipped, "A billion here and a billion there and pretty soon you're talking about real money."

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NOTABLE QUOTE

"It's only when the tide goes out that you learn who's been swimming naked."

Warren Buffett

The Trust Company of the South is a fee-only independent trust company and financial planning firm focused on serving the needs of affluent individuals, families, and non-profit institutions.

Trust Company of the South...because wealth management is more than managing money

WHAT YOU DO NOT UNDERSTAND COULD COST YOU

by John Slayton, JD, LLM-TAX, CFP®

Why am I hearing so much lately about *Fannie Mae* and *Freddie Mac*? I thought they were characters from The Beverly Hillbillies and that show has not aired in years!!

Fannie (a.k.a., The Federal National Mortgage Association) and its sibling, *Freddie* (a.k.a., The Federal Home Mortgage Corporation), enjoy the rarified status of *Government Sponsored Enterprises* (GSEs). We have previously delved into shadow banking, derivatives and stagflation. Today we will investigate the strange and wonderful world of GSEs.

Congress created *Fannie* as a government agency during the Great Depression, to encourage banks to make housing loans through government-guaranteed mortgages. *Fannie* was spun-off as a shareholder-owned company in 1968, to get its fast growing operations off the Government's books, but investors assumed (with the government's apparent acquiescence) that its debt continued to carry the full faith and credit of the U.S. government. In 1970 Congress chartered *Freddie* for the S&L industry, as another shareholder-owned GSE. In 1992, Congress created the *Office of Federal Housing Enterprise Oversight* (OFHEO) to regulate *Fannie* and *Freddie*, but granted it only weak powers and set their capital requirements ridiculously low (2.5% of assets on the balance sheet and 0.45% of non-held, guaranteed mortgages). Today, both *Fannie* and *Freddie* buy mortgages from banks or other originators to provide funds for more mortgages. They hold some mortgages and securitize the rest, adding a guarantee of repayment if a homeowner defaults. Blessed with the private sector's appetite for profit and the government's ability to borrow money, *Fannie* and *Freddie* now own or guarantee almost half of the outstanding U.S. mortgages – *more than $5.2 trillion, yet their combined capital is only $81 billion (1.5%).* What cloud could darken this tranquil, albeit somewhat confusing, landscape?

Not a cloud actually, but a bubble, in real estate, disrupted our idyllic scene. *Fannie* and *Freddie* had always addressed their interest-rate risks from holding long term mortgages and funding them with borrowing by using huge amounts of derivatives to hedge. This led to the accounting scandals several years ago, as *Fannie* and *Freddie* tried to smooth over fluctuations in earnings created by those interest rate hedges. But no one focused on credit default risks, because of a belief that homeowners rarely default on their mortgages. This misconception crashed with the bursting of the housing bubble. Soaring mortgage delinquencies and foreclosures resulted in gushing red ink for *Fannie* and *Freddie*, losing an aggregate $14 billion in the last year. Home prices have continued to decline sharply, leading to more homeowner defaults and foreclosures, further knocking down real estate values – a death spiral.

But I never trusted how a GSE worked, so I did not buy *Fannie* or *Freddie* stock and I am not in the market for a mortgage, so why do I care about any of this?

The short answer is – you will be paying for it. In July, President Bush signed a broad housing bill that, in addition to a $300 billion package of FHA-insured mortgages to help refinance mortgages destined for foreclosure, included an emergency plan authored by Treasury Secretary Henry Paulson to provide a federal backstop for *Fannie* and *Freddie*. The plan removed the $2.25 billion limit on *Fannie* and *Freddie*'s lines of credit from the Treasury through 2009 and permitted the Treasury to buy their equity, if necessary. Separately, the *Federal Reserve* authorized direct lending to both *Fannie* and *Freddie*, as if they were banks. The law created a new independent agency, the Federal Housing Finance Agency ("FHFA"), with increased powers (including requiring higher capital levels) over *Fannie* and *Freddie*, replacing OFHEO. The Fed was also given a consultative role in setting capital requirements and other standards. This represented another step in the Treasury's blueprint for restructuring financial-market oversight and making the Fed responsible for overall stability of the financial system. At the time, Secretary Paulson hoped that merely having authority to intervene would be adequate to calm the markets and allow *Fannie* and *Freddie* to raise needed capital ("If you've got a bazooka and people know you've got it, you may not have to take it out."). Unfortunately, this proved quickly not to be the case.

On Sunday, September 7 (after a very different first version of this article had been completed), Secretary Paulson and the head of the newly-formed FHFA announced a four-step federal takeover of *Fannie* and *Freddie*: they were placed into conservatorship under control of FHFA, the Treasury agreed to buy $1 billion of senior preferred stock and up to $5 billion of mortgage-backed securities guaranteed by *Fannie* and *Freddie* on the open market and an open-ended lending facility was established through the Treasury. The bail-out plan could cost the taxpayers between $50 and $300 billion, but Secretary Paulson indicated that *Fannie* and *Freddie* are "critical to turning the corner on housing" and that the plan should promote stability in the secondary mortgage market and decrease the cost of funding. The common shareholders likely will be substantially wiped out, but the preferred shareholders (many of them banks) will be largely protected and the bond holders will be totally protected. China has amassed $1 trillion in U.S. Treasury and *Fannie* and *Freddie* mortgage-backed debt over the past seven years. Rumors circulated the day before the takeover that the Bank of China planned to liquidate up to 25% of its GSE holdings in order to raise capital. This could have presented the tipping point, causing Treasury to act. *Fannie* and *Freddie*'s securities account for trillions in assets of foreign central banks and many other institutions, that have always assumed the federal government would stand behind the GSEs' debentures and mortgage backed securities. Foreigners' willingness to hold U.S. paper is an important support for the dollar. A former advisor to the Bank of China said allowing *Fannie* and *Freddie* to fail would be catastrophic-- "If it is not the end of the world, it is the end of the current international financial system." Treasury and the FHFA had few choices other than to act.

What will the GSEs look like in the future and what will be the impact of government actions? Not an easy call in an election year. Treasury officials have supported converting the GSEs into types of public utilities. They would be able to raise private money by issuing stock, but their returns (and their executive salaries) would be capped by regulators. Republicans would like to privatize them, while Democrats have argued they deserve public support because of the crucial service they provide in encouraging affordable home ownership. Secretary Paulson indicated it would be a "grave error" if Congress failed to decide the GSEs' future in the next year, because there "are ambiguities and conflicts and structural flaws at the companies that don't do credit to our country." If *Fannie* and *Freddie* were to be restructured as public utilities, they would maintain their hybrid model. If Congress nationalized them, they would become government agencies relying once again on public funding. If they were privatized or liquidated, several large banks have indicated an eagerness to compete in the business of buying loans from mortgage originators. This will likely shake out in the next year.

An interesting point to ponder is: what is the proper threshold for government intervention? Bear Stearns, *Fannie* and *Freddie* were deemed worthy of protection. Lehman Brothers' stock dropped 48% today, when a potential Korean refinancing failed, and General Motors and Ford are clamoring for government funding to develop hybrid vehicles and save them from their retirement/health care obligations. Earlier, we "bailed out" Chrysler, but we let the steel, furniture and textile industries wither on the vine. Once we start down the path of government takeovers, where do we wind up? How do we determine which companies or industries are so strategic that they must be protected at all costs? Is a vibrant domestic auto industry not as necessary as a sound financial system? It certainly was during World War II. Perhaps a lively debate in Congress will ensue?

Even without these government bail-out, credit and real estate problems, the economy faces tough times. Consumer spending is expected to remain under pressure as the job market weakens and higher energy prices sap incomes. Growth in exports, which has helped to underpin our meager economic growth, could diminish with a strengthening dollar and a slowing global economy.

While this situation plays out, please maintain a fully asset-class diversified portfolio, consistent with your cash needs and risk tolerance. We are here to discuss these and any other issues with you at any time.

Did You Receive Stock or Cash From an Insurer In Demutualization?

by Jay D. Eich, CFP®, CPA and Christopher N. Sutherland, CPA

The U.S. Court of Federal Claims recently held against the IRS, in favor of an insurance policy owner, that the proceeds received from sale of stock received when the insurance company converted from mutual to stock ownership were not taxable. The Court held that the proceeds received on the subsequent sale of the stock was exceeded by the total cost basis in the life insurance policy, so there was no taxable capital gain on the sale of the stock. The gain was offset by the basis in the policy, because the value of the stock received was subject to the "open transaction rule." This ruling is complex and the IRS has not yet decided whether to appeal. *Regardless, if you filed a tax return in late 2004 (more likely 2005) or after and you claimed no basis for stock received in a demutualization and subsequently sold, you should consider filing a protective refund claim before the 3-year statute of limitations runs.* Please contact your CPA or us to discuss further.

Behind the Scenes at Trust Company of the South

>> **Jay Eich** was recently nominated to the Charlotte Five Star Wealth Managers directory (Best in Client Satisfaction).

>> **Brandon Cook** successfully completed an advanced Securities Operations course and examination provided by the Cannon Foundation Institute at Notre Dame University.

>> **Chris Sutherland** was recently re-elected as Treasurer to the western region of the Make-A-Wish Foundation. This foundation grants wishes to terminally ill children.

>> **The Trust Company of the South** served as a sponsor to the 2008 Wyndham Championship (a PGA event) in Greensboro, North Carolina this past August.

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For investors in any of these companies, the results have been anything but laughable. And while the shareholders of the firms have experienced staggering losses, the now deposed CEOs of these companies leave with multi-million dollar severance packages. It hardly seems they had a vested interest in the long-term success of shareholders (or clients of the firm) at all.

About a year ago our firm competed with two of these firms for a prospective client. The gentleman questioned us on the "safety" and "risk" of doing business with a much smaller firm. As it turns out, working with a financial behemoth, with access to weapons of mass financial destruction, offered little safety at all. To paraphrase Warren Buffett, "No company, no matter how large, is fool-proof to a sufficiently talented fool."

In retrospect, we didn't emphasize how closely aligned our firm's success was with the client's own success. At Trust Company of the South there are no golden parachutes for the management team; our personal financial success is only achieved by providing our clients with a successful wealth management experience. No shortcuts to juice quarterly earnings, no soft-selling the potential risks of an investment (think auction rate securities), no blurring the line between serving the client in a fiduciary capacity one minute and in a broker suitability standard the next.

All of this begs a serious question: Why should you entrust these large Wall Street firms to manage your hard-earned capital when they've done such a thoroughly poor job of managing their own?

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