



Ambassador Financial Group, Inc.

Back To Basics

The breadth and depth of this credit crisis is far worse than most people anticipated. While many expected that the U.S. housing bubble was going to pop, not many anticipated how far-reaching the crisis would become. Its tentacles have extended globally, moving beyond a credit crisis and morphing into a global economic crisis. Consequently, we are facing a global recession the likes of which we have not seen for generations.

There are many reasons, with the advantage of hindsight, why we find ourselves in this mess. Financial engineering orchestrated by Wall Street was the primary culprit for this crisis, commencing with the creation of esoteric mortgage products. Greed spawned more greed, and the lack of adequate oversight enabled Wall Street to extend the party. The creation of additional unregulated and arcane financial products, such as collateralized debt obligations (CDOs) and credit default swaps (CDS), exacerbated the problem.

While Wall Street led the charge, society and government were complicit in creating this crisis. Americans bought homes they never should have bought. Credit was extended to anyone and everyone who had a pen in hand and the ability to sign on the dotted line. Obviously no other criteria were necessary. The ticking time-bomb officially exploded and shrapnel is still flying through the economic skies.

Many market participants, economists and professors have opined on the spectrum of alternatives for getting us out of this mess. Regulate everything. Regulate nothing. Socialize the system. Capitalize the system. Bail out the banks. Bail out the U.S. autos. I have a simple idea that will put this country on the path to long-term sustainable economic prosperity. Let's get back to basics and pass, what I will call, the Back to Basics Act of 2008-2009, or Double B for short. While it isn't the sexy acronym that TARP is, acronyms don't mean anything. Although still evolving, TARP, which stands for the Troubled Asset Relief Program, by most accounts, has been a comedy of errors, with the rules changing daily. The TARP has not bought one troubled asset. Instead, capital has been injected into the banking system to mitigate the odds of financial Armageddon. In my opinion, the capital infusion

has worked and the threat of a complete banking system failure is off the table. A plan with more substance than style has a better chance of curing our economic woes and I think the Back to Basics Act of 2008-2009 can accomplish that.

Here is how my plan works. Common sense economics has to be ubiquitous throughout every segment of the global economy. Call it a top-down approach or a bottom-up approach. Call it a macroeconomic philosophy or a microeconomic philosophy. Call it whatever you like, but implementation has to occur immediately. From the macroeconomic top-down perspective, countries across the globe have to work in coordination to bring interest rates and currencies back into parity. Market manipulation has to cease in order to avoid artificial carry trades and arbitrage trades that create more risk. When artificial relationships break down, leveraged losses accelerate creating additional problems.

On the first rung of the economic ladder, global oversight of financial markets has to improve. Let me be clear. I don't believe we need to regulate anything and everything. I'm a free market capitalist to the nth degree, and I believe free markets and free trade are the keys to unlocking economic prosperity. However, it is clear now that there was inadequate oversight during the first two-thirds of this decade when excesses emerged. As mentioned above, the housing market got out of control due to the creation of assorted mortgage products. Exacerbating the risk was the creation of esoteric derivative products that escaped regulation. I can go on and on about lack of adequate oversight, but the future looks brighter.

The markets are in the process of creating a public exchange to trade credit default swap contracts, and it appears that this exchange will commence operation in December. This will undoubtedly improve the mark-to-market characteristics of these contracts, removing the subjective mark-to-model method that firms and funds had been utilizing. Under the mark-to-model methodology, both parties in a CDS transaction were marking their position at a profit. Inherently, that can't make sense as typical transactions should result in a zero



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sum game, where one party's profit is the other party's loss. This migration to more transparent markets will improve efficiencies as well as reduce systemic risk. The next logical step in that progression will be to create an exchange for structured products in the fixed-income markets. While we are not there yet, I believe it will be coming.

Moving down a rung on the economic ladder, corporations and businesses must get serious about enterprise risk management (ERM). The ERM theme has been talked about for years, but implementation has fallen short. Excess leverage, financial engineering and concentrated positions among other issues have all contributed to the current environment. Management teams must do a better job of coordinating the ERM process, and boards of directors must protect shareholders and stakeholders by holding management teams accountable.

Sitting on that corporate rung is the middle market institutions which include community banks. While many of you didn't participate in or contribute to the Wall Street excesses, you will be a significant part of the solution. The back to basics theme has to be pervasive throughout the organization to build the "fortress balance sheet" that many of you desire. On the lending side, traditional underwriting metrics have to be reestablished to create a loan portfolio that withstands the most difficult economic times. The good news is that the Countrywides and Wamus of the world won't be around anymore to steal market share with underpriced loans. Additionally, proper loan pricing will be paramount since the loan securitization business has dried up. Consequently, more and more loans will stay on your balance sheets.

On the investment portfolio front, a more conservative investing philosophy has to be considered. Sticking with a diversified mix within the plain vanilla fixed-income spectrum is a better longer-term strategy. Generally speaking, a portfolio comprised of tax-exempt and taxable municipals, with clean credit, seasoned agency pass-through mortgage backed securities with large pools, predictable cash flows and geographic dispersion, short duration blue

chip corporates and agency debentures can achieve this goal and will enable you to rest your head on the pillow at night comfortably. Credit risk is assumed in the loan portfolio and doesn't need to be assumed in the investment portfolio. If a fixed-income security has a story behind it, it probably doesn't make sense. Structured products are designed by Wall Street mathematicians and financial engineers and often perform differently than originally expected. While you might give up a few basis points in current yield, a focus on securities you understand will pay dividends over the long-term.

On the final rung of the economic ladder is the consumer. Common sense economics has to be engrained into consumers' behavior. If one earns minimum wage, purchasing a \$350,000 house probably doesn't make sense. If one earns \$100,000 per annum, purchasing a \$1 million house probably doesn't make sense. Consumers have to do a better job of saving rather than spending so freely. Exercising sound financial judgment will improve the consumer's balance sheet and benefit the entire economic system.

In summary, I believe that the Back to Basics Act of 2008-2009 has the ability to put the global economic system back on a path to long-term sustainable economic prosperity. It will clearly take time to work through the existing crisis but when we come out the other side, I believe we are looking at a secular bull market in equities, not driven by credit, but driven by sound fundamentals. Positive economic growth is attainable, but it will take a collective effort across the board to get back to basics and exercise common sense economics.

Please contact Ambassador if you have any questions or would like a review of your balance sheet.

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The following article is forthcoming in the December 2008 edition of Sheshunoff's Banker's Economic & Investment Alert. Banker's Economic & Investment ALERT (ISSN 1540-3920) is published monthly by ALEX eSOLUTIONS, Inc., 807 Las Cimas Parkway, Suite 300, Austin, TX 78746. Copyright 2008 by ALEX eSOLUTIONS, INC. All rights reserved. No part of this newsletter may be reproduced in any form, by microfilm, xerography, or otherwise, or incorporated into any information retrieval system, without the written permission of the copyright owner. For information, call 1-800-456-2340.