

If you can keep your head when all about you are losing theirs...

I know the events of the past few weeks are causing very great concern. Now that the facts appear to be out in the open, it is horrifying to see what has been happening. I have tried to piece it together to explain it and to put some perspective into what is happening.

INFLATING THE BUBBLE

First bubble element - sub prime mortgages

Every great bull market that turns into a bubble has similar characteristics. It starts with a reasonably good idea. Using long-term mortgages to pay for homes is a good idea, with a few important caveats. These are obvious to anyone who has bought a house; like the need for a substantial down payment, the verification of income, an independent valuation, etc. But human nature is such that, given enough time and the right incentives, any endeavour will be corrupted. This is one of the two critical elements of a bubble. What was once a good idea becomes a farce. The problems with the US mortgage market (and to a lesser extent the UK as well) are now well documented. Loans were eventually given without fixed rates, without income verification, without down payments, and without legitimate valuations.

The lending institutions in the USA have always been able to package their loans and sell them to a larger financial institution. The repayments are passed on to the buyer, as is the risk of default. Originally the biggest buyers of this debt were Fanny Mae & Freddy Mac who sold bonds to the public to raise the money to buy the mortgage debt. These companies collapsed recently under the weight of mortgage default and had to be bailed out by the US government.

As bad as these practices were, they would not have created a global financial panic without the second, more critical element. For things to get really out of control, the farce must evolve further... into unsafe practices, or worse.

Second bubble element - selling the mortgages to banks

As lenders entered into the sub-prime area, they charged higher interest rates to borrowers to account for their risk. They made a higher profit on these and sold them on. With their newly replenished funds the lenders actively sought more high risk debt, as they made more profit. This was the first part of the problem as it sucked people into debt who obviously had no means of repayment. They even devised schemes with 3 - 6 months interest free period at the start, which gave more time for the loans to be sold on before there was any possibility of default.

The next step that started to make the problem more serious was that the banks became buyers of these debts and they created imaginative financial instruments with them. They created a

collateralized debt obligation (CDO) by taking a package of high risk, but high yield debt and adding some low risk debt from "safer mortgages" and persuading the rating agencies to give the CDO a double-A or even triple-A rating on the basis that not everyone defaults on their mortgage payments at the same time. They conveniently forgot about the possibility of serious recession.

The banks then sold these instruments onto other banks to replenish their coffers, enabling them to repeat the process.

Getting carried away – the role of AIG in insuring the sub prime mortgages

Now the whole process starts to get out of hand. The banks that bought the rated instruments used these instruments as security to increase their capital base and borrow more money. This is where AIG comes into the story. Around the world, banks must comply with a set of internationally accepted banking rules known as the Basel II regulations. These regulations determine how much capital a bank must maintain in reserve and are based on the quality of the bank's loan book. The riskier the loans a bank owns, the more capital it must keep in reserve. Bank managers naturally seek to employ as much leverage as they can, especially when interest rates are low, to maximize profits. AIG appeared to offer banks a way to get around the Basel rules, via unregulated insurance contracts, known as credit default swaps (CDS)

To understand how it worked, assume you are a major European bank with a surplus of deposits (Europeans save more than Americans). You are under pressure to maximize the spread between what you pay for deposits and what you can earn by lending. You want something that is safe and reliable, but also pays the highest possible annual interest. You know you could buy a portfolio of high-yielding sub prime mortgages, but doing so will limit the amount of leverage you can employ, which will limit returns.

So rather than rule out having any high-yielding securities (CDOs) in your portfolio, you simply call your friendly AIG broker and ask him to insure this sub prime security against default. The broker agrees to guarantee the sub prime security you're buying against default for five years for say, 2% of face value. This is on the basis that the historical loss rates on American mortgages are so low as to be close to nothing.

Although AIG's credit default swaps were really insurance contracts, they weren't regulated. That meant AIG didn't have to put up any capital as collateral on its swaps, as long as it maintained a triple-A credit rating. There was no real capital cost to selling these swaps; there was no limit. And thanks to "mark-to-market" accounting (which values an asset at the current market price), AIG could book the profit from a five-year credit default swap as soon as the contract was sold, based on the *expected* default rate.

With this structure in place, the European bank was able to assure its regulators it was holding only triple-A credits, instead of a portfolio of sub prime "toxic loans". The bank could leverage itself to the full extent allowable under Basel II. AIG could book hundreds of millions in "profit" each year, without having to deposit billions in collateral.

Apparently, AIG did not have the capital to back up the insurance it sold as it did not expect a default and the profits it booked never materialised. The default rate on mortgage securities underwritten in 2005, 2006, and 2007 turned out to be *multiples* higher than expected and they

continue to increase. In some cases, the securities the banks claimed were triple-A have ended up being worth less than \$0.15 on the dollar.

The CDS market exploded over the past decade to more than \$45 trillion in mid-2007, according to the International Swaps and Derivatives Association. This is roughly twice the size of the U.S. stock market (valued in March 2008 at \$22 trillion, but has fallen a lot since) and far exceeds the \$7.1 trillion mortgage market and \$4.4 trillion U.S. treasuries market.

The credit bubble

The CDS market worked for over 10 years. Banks leveraged deposits to the hilt. Wall Street packaged and sold sub-prime mortgages as securities (CDOs). AIG sold credit default swaps without bothering to collateralize the risk and so an enormous amount of capital was created out of thin air. Nobody is really sure how far the contagion spread. Certainly we have seen the European banks write off tens of billions of dollars of this bad debt in the past year and it is by no means all written down even now. There are strong rumours around Geneva (where I am at present) that we have barely seen half the debt declared and written off.

The Middle Eastern banks have declared that they did not become involved in the CDO and CDS markets. It is not clear whether Asian, Russian, Chinese or South American banks were involved, however it does seem to have been more of a USA & European phenomenon.

BURSTING THE BUBBLE

Collapse of AIG

On September 15, all of the major credit-rating agencies downgraded AIG – the world's largest insurance company because of the soaring losses in its credit default swaps. The first big write-off came in the fourth quarter of 2007, when AIG reported an \$11 billion charge. It was able to raise capital once, to repair the damage. However, the losses kept growing. The moment the downgrade came; AIG was forced to come up with tens of billions of additional collateral, immediately. This was on top of the billions it owed to its trading partners. It didn't have the money. The world's largest insurance company was bankrupt.

Collapse of Lehman Bros

The dominoes fell over immediately. Suddenly the banks were forced to downgrade the securities they were holding, which meant their capital requirements had to be raised. Worse, if AIG was bankrupt, the banks had no credit insurance and had to write down their CDOs. Lehman Brothers failed on the same day. Merrill was sold to Bank of America. The Fed stepped in and agreed to lend AIG \$85 billion to facilitate an orderly sell off of its assets in exchange for essentially all the company's equity. That is how AIG became the linchpin to the entire system. However, the Fed decided not to rescue Lehman Brothers, America's 5th biggest investment bank, and that was their big mistake as it immediately undermined confidence in the banks. If a major bank was allowed to go bust, then in the present circumstances, no bank could be trusted. Confidence in banks collapsed overnight.

AIG's largest trading partner wasn't a nameless European bank. It was Goldman Sachs. Goldman had avoided the huge mortgage-related write-downs that plagued all the other

investment banks by hedging its exposure using credit default swaps with AIG. Sources inside Goldman say the company's exposure to AIG exceeded \$20 billion, meaning the moment AIG was downgraded, Goldman had to begin marking down the value of its assets. The moment AIG went bankrupt, Goldman lost \$20 billion. Warren Buffet stepped in and invested \$5 billion, which also helped it raise another \$5 billion via a public offering.

The collapse of the credit default swap market also meant the investment banks had no way to borrow money, because no one would insure their obligations. To fund their daily operations, they've become totally reliant on the Federal Reserve, which has allowed them to formally become commercial banks. As at last week, banks, insurance firms, and investment banks have borrowed \$348 billion from the Federal Reserve – nearly all of this lending took place following AIG's failure.

Why the rescue?

I have gone into this detail because:

1. Without the government's actions, the collapse of AIG could have caused every major bank in the USA and Europe to fail, which would in turn bring down most banks in the world as they all lend to each other. However, letting Lehman Brothers go bankrupt was not such a good move and has been severely criticised.
2. Without the credit default swap market, there's no way banks can report the true state of their assets – they'd all be in default of Basel II. That's why the government will push through a measure that requires the suspension of mark-to-market accounting. Essentially, banks will be allowed to pretend they have far higher-quality loans than they actually do. The credit default swap market cannot provide cover anymore.
3. Most importantly, without the massive credit swap market initiated by AIG, the mortgage bubble could have never grown as large as it did. Other factors contributed, such as the role of Fannie Mae and Freddie Mac in buying sub prime mortgages without questioning their quality, but the key to enabling the huge global growth in credit during the last decade can be tied directly to the sale of credit default swaps without underlying collateral. That was the stable door. And it was left open for nearly a decade.

There's no way to replace this massive credit-building machine; the credit that existed in the world before September 15th should not have been there in the first place. The numbers are massive, as we have seen by the scale of the government bailout schemes announced by the US and UK governments followed by other major national governments.

CONFIDENCE

The whole financial system is based on confidence. It starts with you and me. When we have our salary paid into a bank, we do so because we are confident the bank will honour our cheques and card payments and that their ATMs will deliver.

Banks earn money by lending our hard earned cash and that of our companies to other entities. They lend to home buyers, to businesses and to other banks and they do so in the confidence that they will receive interest and be able to get the money back, or in case of default, own an asset of equivalent value. As we have seen above, banks can borrow more money than is deposited and lend that out as well. The majority of bank lending is long term. For the system to work, the banks have to be able to raise money to meet short term obligations. They can borrow from the Central Banks short term, but most of the borrowing is between banks.

Crisis of banking confidence

When Lemman Brothers went bust, the banks realised they could not rely on the government to bail out a troubled bank and knowing that there were still huge unquantified losses on bank balance sheets and that the credit default insurance market had collapsed, no bank could be confident that even a big name bank would be able to return money it borrowed. Immediately, the banks stopped lending to each other. Without the ability to raise capital, the banks stopped lending to the public and to businesses. So we saw panic amongst the banks that created an immediate credit crisis. There was no longer any confidence in the banking system and so governments have been forced to step in.

Crisis of business and stock market confidence

The next crisis of confidence came amongst corporations. Companies were having trouble obtaining loans and then suddenly found their banks reneging on commitments already made. Credit lines were withdrawn or called in. Companies could no longer be confident of being paid by their customers and were also finding some of their suppliers going out of business. The stock market was quick to recognise the implications of this and confidence in share prices slumped. Most of the world's stock markets were down 20-30% over the past year and then panic set in last week. Markets dropped by another 25-30%. Most western markets are currently sitting some 40% below their highs of a year ago and the re-emerging markets have dropped up to 60%.

Iceland becomes bankrupt

In some cases, the market capitalisation (share value) is less than the asset value (buildings, stock, cash etc) of the company. The sudden drop in share value is causing problems for investment banks who have invested in corporations. This triggered the collapse of the Icelandic banks. They had embarked on an ambitious program of raising money by offering interest rates in the region of 15% -16% and the UK government encouraged local authorities to deposit their money with Icelandic banks. The Icelandic banks invested this money in British and other overseas companies. They had taken on collective debt exceeding 4 times the Icelandic gross domestic product (GDP). When share prices collapsed, they became insolvent and the Icelandic government does not have nearly enough money to bail them out or to guarantee depositors. The country is bankrupt and the obvious place for it to turn is to the IMF.

So a vicious circle starts to build. The credit bubble burst and confidence has evaporated. Banks have no confidence in each other and so cannot lend and this has a knock-on effect to mortgages and property prices, to everyday business between companies and then on to all asset prices. We have seen it move from a loss of confidence to blind panic.

UNWINDING

The effect of panic is that institutional investors generally sell out first. The panic then spreads to the public who sell shares and withdraw money from their mutual funds. This triggers a second round of selling by institutional fund managers who have to sell to cover redemptions. Hedge funds have been made scapegoats for short selling, but the reality is that they have not played a major part in the fall of bank shares. The banks' shares dropped far more during the ban on short selling than before it. Hedge funds are playing their part in the share price drop however; they have borrowed money to invest and as share prices and commodity prices have dropped, the banks have called in loans which necessitated the hedge funds selling some of their holdings in shares and commodities. We saw oil and gold prices drop as well as shares.

The mini crash of 1998 was caused by the collapse of LTCM (the world's largest hedge fund at the time) following Russia's default on foreign debt and recovered quickly. This time, the hedge funds have held up well. The main reason being that the owners invariably invest their own money and control what the fund invests in. Bank senior executives often have little understanding or control of their dealing desks. We saw that with the collapse of Baring years ago and the rogue trader at Societe General earlier this year.

WHAT NOW?

Well, this is difficult to predict as we are in uncharted territory. It has taken time for the severity of the situation to sink in with most governments. If they have been too slow to react, the IMF has given them a shake up this weekend by saying that we could see a major melt down in the world financial system if governments do not take strong action. As I write, more and more governments are coming out to support their banks.

We can be sure we are not at the end yet. There is more bad debt on the books of the banks that has not been fully written off yet. A change in accounting rules may stave off some of this, but there is still a problem. The equity markets are badly shaken and will undoubtedly be very volatile for some time to come.

The shock of it all has triggered a lack of confidence which takes time to be restored and will affect us all. The removal of the credit mountain will cause an economic slowdown, but the worry that ensues will filter down to the consumer, who will stop spending - even if he has the money to spend - and this will push the slowdown into recession. There is much pessimism around and many comparisons to the great depression of the 1930s. You have to remember when assimilating the news that bad news sells papers and keeps people glued to the news channels, far more than good news. Gloomy predictions sell better than optimistic ones. The news channels know this.

America is likely to bear the worst brunt of this, with UK close behind and then Europe. It is harder to predict the effect on the emerging markets. They will undoubtedly slow down as their export markets dry up, but the larger emerging countries have started to develop a domestic market and a new middle class and they do not carry the bad debt of the western banks. China is sitting on over \$500 billion of US Treasury Bills. However, China has already started to feel the impact of a slow down with some 20 million jobs being lost already this year, according to the Sunday Times. This sounds a lot, but you have to remember they have a population of over 1.3 billion, - more than 4.3 times that of USA.

Not another "great depression"

The IMF said on Wednesday that despite this being the greatest shock to the financial system since 1929, the chances of a 1930s style depression are "nearly nil" They predict that global growth will slow to 3.9% this year, down from 5% last year, and drop to 3% next year. This does assume that western governments will respond in the right way to the crisis. They predict that emerging markets will fare better in 2009 than the G7 countries, with China growing at 9.3%, India at 6.9%, Russia at 5.5%, Middle East at 5.9% and USA and Europe at zero. Given the time between the research and publication, these figures could be a little on the high side now, but it serves to demonstrate that the emerging markets are likely to be more robust in the coming years than those of the G7 countries.

It is unlikely that the Middle East property boom will continue as it has. Confidence will be affected and international buyers from outside the Gulf may be forced to sell if they have bought on credit.

Political change

On the political side we are likely to see major changes. Gordon Brown will no longer be able to proclaim "the end of boom and bust". However to be fair, he has acted decisively and led the world out of the banking crisis, creating a better rescue package than Hank Paulson created for the USA.

Western governments will end up holding major stakes in their big banks and insurance companies to restore confidence. In some cases, they will be nationalised. This will lead to a return of solid banking principles and rein in the wilder activities of the bank dealing rooms. It could also lead to political interference and inefficiency in banking as politicians are rarely qualified bankers. Undoubtedly, we will see more financial regulation and this will have a restrictive effect on financial services, much of which is already sinking under a weight of heavy handed legislation since 9/11.

COMMONSENSE

Clearly it does not make sense for company share prices to drop below asset valuations and we will see some major investments, mergers and takeovers, once commonsense is restored. Look out for those with large cash reserves, notably the sovereign wealth funds of the emerging economies making more strategic investments in western companies. The wealthiest man in USA, Warren Buffet, who is also accredited as being America's most astute investor, has already invested some \$10 billion that we know of.

Whenever we have seen major falls of this magnitude due to panic, there is normally a rebound that follows as commonsense is restored. This may not be back up to original levels but nonetheless, is significant. Thereafter, it is anyone's guess as to what will happen.

Given that the entire financial system is built on confidence, then we or the press, are in danger of talking ourselves into a bigger recession than would otherwise occur. Once confidence is restored by governments around the world in the banking system, then we should see calm restored. That is different to market and business confidence coming back. That will take longer as we still have to get over the removal of the credit bubble. We need companies to be confident about investing and consumers to be confident about spending.

INVESTMENT PERFORMANCE

With markets going up or down by 5% or more in a day, it is difficult to give any meaningful performance data at present. As I started this, markets had dropped 5-7% on Friday. Now on Monday, they appear to be recovering the same amount. The Dow Jones Industrial index reached a peak last October of 14198 and the S&P500 of 1576. On Friday 3rd, they closed at 10325 & 1099, down 27% & 30%. On Friday 10th, they closed at 8451 & 899, down 41% & 43%. Emerging markets have dropped even more, but these tend to be more volatile and tend to exaggerate "knee jerk" reactions.

Over the 12 months to last Friday, 10th October, Collins Stewart Aggressive fund (now renamed to Collins Stewart Global Opportunities Fund) was down 23.5% and the Collins Stewart Growth fund (now renamed to Collins Stewart Select Global Affinity) was down 26.5%. However, FPI have not updated their prices for 2 weeks, since Collins Stewart moved the funds to Dublin. I am pressing them to do this as soon as possible, but it looks as though the Global Opportunity Fund is down some 29% and the Global Affinity Fund is down over 40%. Collins Stewart were more heavily invested until the end of September when they sold everything in the Global Opportunity Fund and went 100% to cash, but have since invested 30% back into the market in the dips. The Global Affinity Fund remained invested.

The 2 Lanson funds did much better, but were both down by 16.5%. Lanson has maintained a high cash weighting all year of some 70% which has served them well over the period.

By contrast, other global equity funds were down some 40% and emerging market funds by up to 60%.

The hedge funds have done better, MAN AHL (+16%), Thames River Mainstay (-2%) and Momentum All Weather (-4%).

The Brandeaux Ground Rent (+8%) and Student Accommodation (+10%) Funds continue to do well and are largely unaffected by any of the current crises. These funds are restricted by Friends Provident to investment of new money and do not allow existing investments to be switched in.

However, by today the picture could look very different as markets are improving.

GLOOM & DOOM - WHAT TO DO?

As the overwhelming majority of our clients have invested for the long term, there is no need to panic. Markets always recover. This time the general sentiment is that the emerging markets' stock exchanges will lead us out of this crash, as things settle down.

The funds of funds with FPI managed by Lanson & Collins Stewart have considerably outperformed the market and protected investors. The same is true of the Zurich AIP and their in-house managed funds.

With all the scaremongering around, you may feel like selling, but unless you foresee a short term need to raise cash, this is not sensible. In fact, the opposite is true. As you can see from

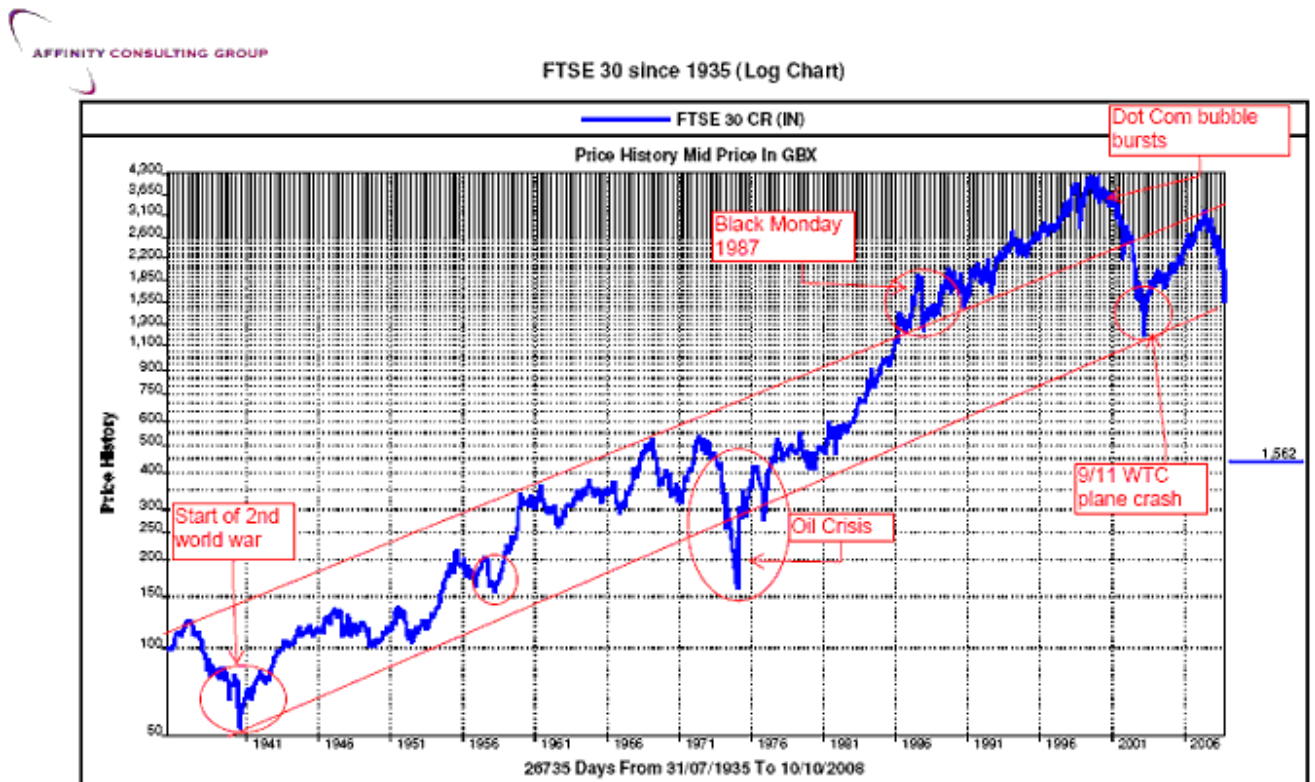
Warren Buffet's lead, it is a good time to be investing and for those with monthly savings plans, you are buying your funds very cheaply now.

Commodity prices have dropped as speculators who were buying on credit have been forced to sell. This is why gold dropped, when the normal reaction would be for it to rise in times of uncertainty.

There are some bargains around now and it is a very good time to be investing. If your local car showroom was to display a sign saying that cars were now half price, I think that a queue might form. We have the same situation in stock markets and we saw a queue form last week. However the queue was selling. A few knowledgeable investors have crept in the side door to buy from those who are panic selling.

It is not all bad. In times of recession we need people who can afford it, to keep spending. We will see prices reduce, food is coming down, oil has dropped 40% bringing down fuel costs and air fares. Asset prices will reduce, property in the west has already dropped and is more affordable now. Rents will come down as property prices reduce. Stock markets will recover and continue to grow, they always have. All of this may be painful for some people in the short term, but it will provide opportunities for others.

Past crashes analysed



Source: Lipper. Produced using Hindsight 5 by Lanson Financial Limited.
Hindsight is a registered trademark of Reuliers Limited.
User may have modified the original chart and axis titles provided by Lipper.

The value of investments can fall as well as rise. Past performance is no guarantee of future performance.

The above chart is the oldest time period available and charts the top 30 UK shares for the past 73 years on a logarithmic scale (which squashes the scale over time) so it is easier to follow. I have included it to reinforce the point that whenever there have been sudden crashes in the market, a partial recover follows very quickly. As with any rule, there is always an exception and that was the 1987 black Monday crash which took nearly 2 years to recover.

As always, there is no universal advice that applies to everybody, as all circumstances are different. Trading for the short term to try and time a market falls into the realms of speculation. It can be very profitable, but the risks are very high. The key to long term investing is asset allocation and diversity. This is provided by the "funds of funds" managed by Lanson Financial and Collins Stewart and by the automated retirement strategy offered by Zurich. Of course, it is possible to do this yourself and to devise a mix of funds to suit your investment timeframe and risk profile and we would be pleased to assist.

Collins Stewart Funds

Please be advised that Collins Stewart have revamped their funds and moved them from Guernsey to Dublin, primarily for marketing reasons. They have been renamed as follows:

CS Balanced GBP becomes	CS Select Diversity
CS Balanced USD becomes	CS Select Global Diversity
CS Growth GBP becomes	CS Select Affinity
CS Growth USD becomes	CS Select Global Affinity
CS Aggressive GBP becomes	CS Select Opportunity
CS Aggressive USD becomes	CS Select Global Opportunity

YOUR FPI ACCOUNT

You can now access your Friends Provident Account on-line to see your daily valuations. To register, click the link <http://www88.friendsprovident.com/international/index.jhtml>

Friends Provident, in common with most financial institutions have put out a statement confirming their strength and stability. Friends Provident issued a statement to the London Stock Exchange on Friday reiterating it's financial strength and strong capital position. A link to this article can be found here: <http://uk.biz.yahoo.com/081010/214/i8g39.html>

ALTERNATIVE INVESTMENTS TO STOCK MARKETS

From a long term perspective, this is a good time to be buying equities, but we appreciate that many readers do not have a long time horizon or do not want the risk. In this case, there are alternatives. I have mentioned the Brandeaux Ground Rent & Student Accommodation Funds, which are insulated from all markets and have turned in a consistent performance of 7% - 10% per year for 10 years.

Another asset class that is not dependent on markets is American Traded Life Policies. These are unique to USA. Managing Partners Limited has been managing several funds of these policies for some 4 years, buying life insurance policies of Americans in retirement who no

longer need them. They now have USD, GBP & EUR versions of the fund, all showing growth of 9% p.a. or more.

A similar concept is used to run a fund of Traded UK Endowment Policies - The Protected Asset TEP Fund, also available in 3 currencies. This fund buys UK endowment policies from people who want to surrender them for a higher price than they would achieve by giving them back to the insurance companies that issued them. It has achieved approx 6.5% - 7.5% per annum, depending on currency, since launch in 2003.

The Ganoz High Yield Forex Funds are only related to currency markets and provide diversification. There is a high yield fund and also 2 fixed income funds (10.5% pa over 5 years or 11.5% pa over 3 years) with capital protection from Credit Suisse. These are in USD only.

Please contact us for more information. Bear in mind that in Singapore some of these funds are only available to experienced investors as defined by the MAS.

AND FINALLY...

There was a one line report from the report of the receiver for Lehman Brothers upon seeing their balance sheet.

"There are two sides to a Balance Sheet, the Left & the Right (Liabilities and Assets respectively). On the left side there is nothing right and on the right side there is nothing left"