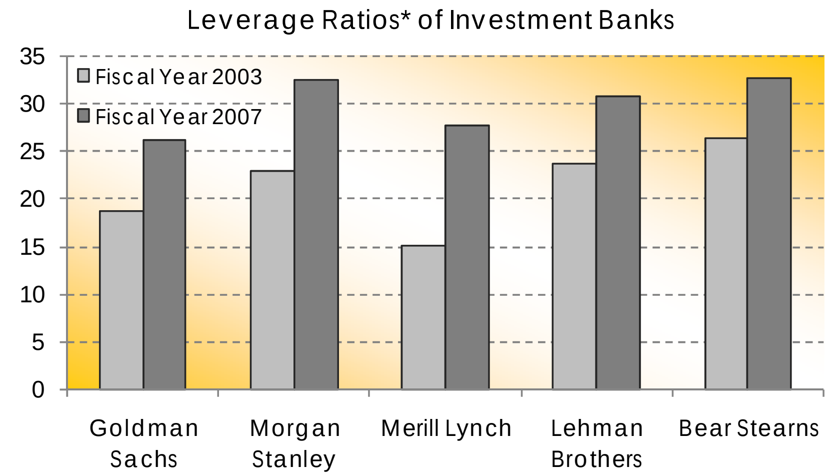
Several weeks after Hurricane Katrina hit New Orleans, former General Electric Chairman and CEO, Jack Welch, published an article in the Wall Street Journal about crisis management ("The Five Stages of Crisis Management," The Wall Street Journal September 14, 2005). He presented the storm and its aftermath as a veritable case study of the five stages people seem to go through during a severe crisis: denial, containment, shame-mongering, blood on the floor, and finally repair. Unfortunately in the case of most crises, things get worse before they get better. The storm currently swirling in the financial markets is no different. Although it was in no way designed by Mother Nature, the early chaos surrounding the management of the crisis is reminiscent of what immediately followed Hurricane Katrina. The good news is that we are likely in the final stage of working through the natural pattern of this crisis. In the piece below we apply the five steps defined by Jack Welsh to the credit crisis. We examine the long and arduous path we have been down, and discuss how the global financial community is trying to rebuild its levees and convince investors who have evacuated to return home to the markets.

1. *"The first stage of that pattern is denial. The problem isn't that bad, the thinking usually goes, it can't be, because bad things don't happen here, to us."*

Denial during the build-up of this crisis came in many forms, but at the core was a disregard for the basic principles of economics. Greed dominated rational and risk-aware analysis in a way that put the 1980's to shame. At Miracle Mile Advisors, we like to lighten the weighty material we present to clients with relevant, and sometimes humorous, quotes from famous investors. One of our favorites was coined by Sir John Templeton who said, "The four most dangerous words in investing are, *'This time it's different.'*" Short-term dislocations in financial markets may create temporary opportunities for easy profits, but risk and reward will always be opposite sides of the same coin. Eventually the number of people piling into a "sure thing" brings about the end of the opportunity for a free lunch. Just as cab drivers making huge profits as day traders marked the height of the Tech bubble, stories of zero-money-down home buyers with no verifiable income surely foretold the end of the housing boom and the beginning of the crisis.

People buying homes they could not afford were by no means the only ones denying reality. Home owners across the income spectrum took the one-way bet that the values of their homes would never decline, using them as ATMs to finance everything from their children's college education to vacations to second and third investment properties. Mortgage brokers and bank lending officers ignored signs that borrowers were overextended. Hedge funds took advantage of easy credit to leverage their assets (and risk) to unprecedented levels. Heads of trading desks ignored risk managers who warned that merely dividing and repackaging risk did not eliminate it. The Federal Government believed that the purest form of capitalism would provide enough incentive to self-regulate risky behavior in the markets.



* Ratio of total assets to total shareholders' equity and preferred stock

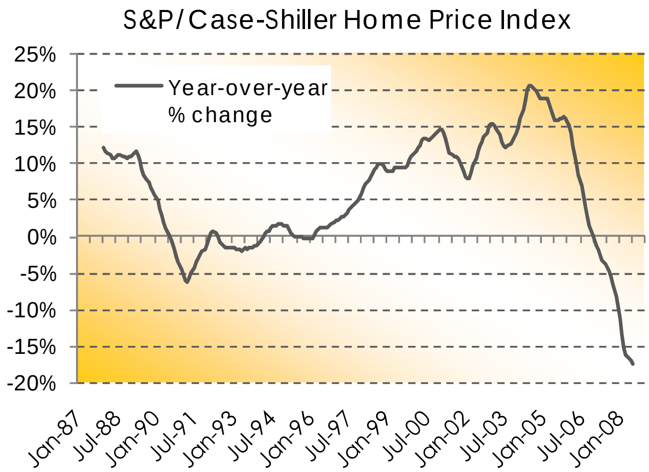
One of the most overt displays of risk-denial came in 2004 when the big five investment banks lobbied the Securities and Exchange Commission to obtain an exemption from the so-called "net capital rule." This rule limited the amount of debt that investment banks' brokerage units could take on by regulating a certain level of reserve assets. In April 2004, the SEC bowed to the investment banks' request and abolished this rule for banks whose assets exceeded $5 billion. This action acted as a leverage multiplier by freeing up billions of dollars of cash reserves originally intended to act as a buffer for potential investment losses. The SEC further turned a blind eye by deciding to use the banks' own quantitative models for determining the riskiness of their investments. Common thinking at the regulatory body was that the firms had a strong culture of self-preservation, which would prohibit excessive risk taking. However, once this culture of leverage was imbedded in the banks' business models, it would have been difficult for any Wall Street executive to swim against the tide and keep his job. Any bank not posting earnings commensurate with its peers would have seen its Chairman driven out by throngs of angry shareholders.

Even when the unwinding was well underway late last summer, the architects of the derivative securities at the heart of the crisis continued to defend (and deny) the inevitable. In a quote referencing the ill-fated CDO insurance products that ultimately brought down AIG, the former head of the company's Financial Products division epitomized the belief system that brought us to where we are today:

> *"It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions."*
>
> - Joseph J. Cassano, former head of AIG Financial Products, August 2007

2. *"The second is containment. This is the stage where people, including perfectly capable leaders, try to make the problem disappear by giving it to someone else to solve."*

In a sense, the whole idea of securitizing these high-risk mortgage loans was a form of containment. Slicing sub-prime mortgages into tranches, packaging them into bundles with some slightly higher-quality loans, and reselling them as investment grade securities allowed banks to move questionable loans off of their balance sheets and continue to lend. In theory, this should have made the banks more resilient to financial shocks by insulating them from defaults and expanding the liquidity in the marketplace. The



problems began when the unthinkable happened: housing values severely declined causing the collateral backing the securitized assets to take a hit. As defaults mounted, banks were called upon to provide liquidity to this complicated, inter-connected structure, thereby transferring the credit risk back onto their balance sheets. Containment of risk failed, at least from the banks' perspective.

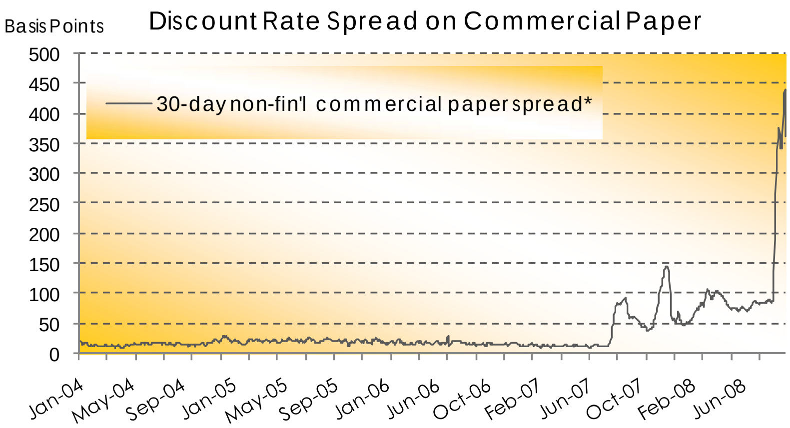
3. *"The third stage is shame-mongering, in which all parties with a stake in the problem enter into a frantic dance of self-defense, assigning blame, and claiming credit.*

Once it became clear that the crisis would not be contained to just subprime mortgage lenders such as Countrywide, the bob and weave began. Wall Street banks assured anyone who would listen that they were adequately capitalized. Two days before Bear Stearns CEO, Alan Schwartz, warned government officials that the bank might need to file for bankruptcy, he was live on CNBC telling viewers that his firm was sound and projecting a profit in 1Q 08. While this may not have been a blatant lie at that moment, it was certainly overly optimistic. Sudden demands for cash from counter-parties and rumors that hedge funds were shorting the Bear stock prompted a hasty weekend marriage between Bear and JP Morgan. Thus began a series of high profile collapses (and near collapses) which would claim Freddie Mac and Fannie Mae, Lehman Brothers, Merrill Lynch and AIG. As the finger pointing continued, the blame game helped fuel a vicious downward spiral in confidence. Banks would not lend, even to each other, for fear that the counter-parties could not repay the obligations. The stock market began to tumble as investors funneled money into the safety of short-term Treasurys, avoiding even money market funds which had suffered from owning paper backed by Lehman Brothers.

The administration eventually realized that a coordinated bailout package was necessary, which brought Congress into the mix. Members of the House of Representatives claimed that 95% of constituent calls expressed opposition to any bailout package. Average people expressed anger that their tax dollars were being used to bail out a banking system that had rewarded Wall Street hotshots with multi-million dollar pay packages. The message sent to Washington was that the average American would rather stand in a bread line and watch the Wall Street elite suffer, than support a bailout plan for investment banks. Congressional Democrats blamed the Republicans for years of lax regulation. Congressional Republicans jumped on the populist bandwagon opposing government intervention in private markets with tax payer money, and pointed the finger at House Speaker Nancy Pelosi for politicizing the rescue plan vote. Regardless of who won the blame game, confidence was the biggest loser of the day. Investors responded with a nearly 9% one-day sell off in the S&P 500 index. This began a two-week period that would see both the Dow Jones Industrial Average and the S&P 500 lose roughly 25% of their value.

4. *"Fourth comes blood on the floor. In just about every crisis, a high profile person pays with his job, and sometimes he takes a crowd with him."*

Former Lehman Brothers CEO Richard Fuld was likely the highest profile sacrificial lamb of the crisis to date. When the government decided to let Lehman Brothers fail, Fuld lost his job and his firm, as well as the entire value of his stock along with shareholders. He was brought to testify in front of Congress and literally and symbolically held accountable for all of the ills of the credit crisis. Not that anyone is crying for Richard Fuld.



*A2/P2 less AA non-financial commercial paper rate, 5-day moving avg.
Source: Federal Reserve Board Commercial Paper data release

Many market observers now feel that letting Lehman fail was a mistake given the fallout in the commercial paper and money market arenas. At the time, however, the government was looking for a poster child to prove they had not succumbed to "moral hazard[1]" in bailing out Bear Stearns. As a result, one of the biggest investment banks in the world collapsed, taking with it tens of thousands of jobs and billions of dollars in lost capital. To be sure, Lehman's employees and management have not been the only casualties. Management teams at Freddie Mac, Fannie Mae, and AIG were unceremoniously dispatched. Merrill Lynch folded into Bank of America, and Morgan Stanley and Goldman Sachs were forced to become commercial banks. Job losses across many industries have mounted, and both professional and amateur investors have racked up losses in mutual funds, hedge funds, 401(k)'s and college savings plans. Politically, Republicans are paying the price for being the party in charge for the last 8 years, as voters clamor for anything but the status quo. There has been a pure psychological purge of optimism.

5. *"In the fifth and final stage, the crisis gets fixed and, despite prophesies of permanent doom, life goes on, usually for the better."*

The saying goes, "what doesn't kill you makes you stronger." There will always be unforeseen challenges, but we believe that the global financial system will recover and adopt the particular lessons of this crisis. We anticipate better risk management systems,

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[1] Moral hazard is the idea that a person or entity backed by a form of insurance will take greater risk than they normally would without it. In this situation, the fear was that companies would be encouraged to take on undue risk if the federal government set a precedent to bail out those that fail.

more stringent capital requirements (a given since the remaining investment banks are now more-regulated commercial banks) and more oversight of derivatives, swaps and hedge funds. Our hope is that the eventual solution will produce better, not just more, regulatory requirements.

It is likely that due to more oversight and regulation, and lower pay checks, the draw of Wall Street professions will be diminished. This could encourage more entrepreneurial behavior, and eventually broaden our economy. We expect that interest in independent advisory firms, such as Miracle Mile Advisors, will continue to grow as institutional and individual investors purge the long-held belief that bigger firms are safer.

We expect credit conditions to remain relatively tight in the short-to-medium term. However, we do not necessarily view more stringent lending conditions as a net negative. Clearly credit conditions had become too lax when "stated income" home loans were being approved for individuals with 0% money down. For businesses, the recent shut down of the commercial paper market will force many CFOs to reassess the long term viability of relying so heavily on debt markets to finance short-term cash flow needs.

As we mentioned at the beginning of this piece, sometimes the most dangerous words in investing are "this time it's different." This holds true today at a trough of pessimism, just as it did at the peak of optimism. It was illogical to believe that housing prices would always rise exponentially, as now it makes no sense to project this level of doom and gloom indefinitely. The world is not ending, and financial markets are not imploding to zero. In the investment world, retrenchments provide opportunity, and contrarian investors will likely look back on this period the as the buying opportunity of a lifetime. For now though, the equity markets still seem to be gyrating wildly on fear and lack of clarity. Once we see equities again trading on fundamental underpinnings such as earnings or economic growth, we will feel more comfortable buying into this trough. We maintain reduced positions in U.S. and International Developed Market equities, and overweight positions in cash equivalents.

October 17, 2008

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