Everything you always wanted to know about financials*

*But were afraid to ask

The instability of banks and their tightening lending practices are having far-reaching consequences. For some families, foreclosures and home short sales have become realities as adjustable rate mortgages reset and the value of their homes continue to decline. Other families are receiving letters that home equity lines of credit are being cancelled while access to their "cash" equivalent investments are locked up in an unredeemable auction rate security. For those families lucky enough to escape these problems, the more palpable change has been a psychological shift in their definition of financial security. Many Americans are now questioning the safety of their checking accounts/money markets in tandem with their more complex, structured debt products. A year into the so-called "subprime mortgage crisis," we are still discovering how broadly and deeply the credit bubble reached, and trying to determine if the end is in sight. In this piece, we examine some of the important issues surrounding this financial crisis and the Financial sector. First, how are we exposed to financial stocks? Second, how have Financials fared and where do things stand today? And finally, how will we know when the crisis is over?

Trading Places

Until the recent decline, the Financials sector was the largest in the S&P 500 index. Today, for the first time since the dot.com meltdown, Technology leads the pack. The table below shows where Financials rank in some of our major equity ETF holdings.

Sector Weightings in Equity ETFs

U.S. Equity						International Equity							
S&P 500 (IVV)		Russell 2000 (IWM)		Russell MC (IWR)		MSCI Canada (EWC)		MSCI EAFE (EFA)		MSCI EM (EEM)		S&P Latin Amer. (ILF)	
Info. Tech.	17%	Financial Services	20%	Financial Services	20%	Financials	30%	Financials	26%	Financials	19%	Materials	34%
Financials	16%	Cons. Discret.	15%	Cons. Discret.	16%	Energy	29%	Industrials	12%	Energy	19%	Energy	18%
Energy	14%	Health Care	14%	Technology	11%	Materials	20%	Materials	11%	Materials	17%	Financials	15%
Health Care	13%	Technology	14%	Utilities	9%	Info. Tech.	6%	Cons. Discret.	10%	Info. Tech.	13%	Telecomm.	13%
Industrials	11%	Materials	9%	Materials	9%	Industrials	5%	Energy	8%	Telecomm.	12%	Cons. Staples	10%
Cons. Staples	11%	Producer Durables	8%	Other Energy	9%	Telecomm.	3%	Cons. Staples	8%	Industrials	6%	Utilities	5%
Cons. Discret.	8%	Other Energy	7%	Producer Durables	8%	Cons. Discret.	3%	Health Care	7%	Utilities	4%	Industrials	2%
Materials	4%	Utilities	4%	Health Care	8%	Cons. Staples	2%	Utilities	6%	Cons. Staples	3%	Cons. Discret.	2%
Utilities	4%	Auto & Transport	4%	Cons. Staples	4%	Utilities	1%	Telecomm.	6%	Cons. Discret.	3%	Cash	0%
Telecomm.	3%	Cons. Staples	3%	Auto & Transport	3%	Health Care	0%	Info. Tech.	5%	Health Care	2%		
S&P 500 Value (IVE)		Russell 2000 Value (IWN)		Russell MC Value (IWS)									
Financials	27%	Financial Services	34%	Financial Services	32%								
S&P 500 Growth (IVW)		Russell 2000 Growth (IWO)		Russell MC Growth (IWP)									
Financials	6%	Financial Services	7%	Financial Services	9%								

Note: Ticker symbols in parentheses. Index named is the index tracked by the ETF.
Source: iShares

From these numbers, it is obvious why the broad markets have been moving in tandem with financial stocks. They also highlight why ETF selection in specific styles and regions is crucial in a market like this. If you look at the breakdown for Value and Growth indices in the U.S., the Value funds carry around three-to-five times the Financials weighting of their Growth counterparts. Not surprisingly, Value indices have trailed Growth significantly year to date. While most of the international ETFs also carry a significant Financials allocation, it is important to examine the extent of their exposure to the crisis. For example, we introduced Canada as part of our North American allocation to take advantage of our northern neighbor's limited exposure to subprime mortgages. The same is true of banks in the emerging markets, while conversely we have lightened up on our developed international exposure (EAFE) as member countries such as the U.K., Spain and Ireland become increasingly mired in a housing and mortgage bust.

The Perfect Storm

To paraphrase a line from *"Shrek"*, this financial crisis is like an onion…there are a lot of layers. Originally, the financial challenges appeared to be just a bubbling over of the low-quality mortgage market. However, as the layers below the surface gradually revealed themselves, we started to realize just how far the implications could reach. So far we have seen a subprime meltdown, a rash of housing foreclosures, a severe devaluation of structured mortgage-backed assets, ensuing write-offs, a liquidity crisis, the near failure of an investment bank, the failure of a commercial bank, a crisis surrounding the viability of Freddie Mac and Fannie Mae, and a near-moratorium on lending. Is this laundry list the worst of what is out there? **Probably, but we are not ready to call the bottom.**

Without clarity on a housing-market bottom and a signal that banks have at least identified the extent of write-offs to come, it is impossible to predict when banks will expose their balance sheets to additional risk and lend. Take for example the agreement recently announced by Merrill Lynch. On July 17, Merrill CEO, John Thain stated on a conference call that he would not do anything "dumb" such as sell assets "at any price we could get." He assured investors that Merrill was in a "very comfortable spot in terms of our capital." Then less than two weeks later, he agreed to sell a large package of mortgage-backed collateralized debt obligations to distressed debt investor Lone Star Funds for 22 cents on the dollar. In addition to the bargain-basement price, Merrill agreed to provide Lone Star with 75% of the money required to buy the assets. In order to finance this write down, Merrill announced it will raise $8.5 billion in new shares. Not only does this further dilute existing shareholders' positions, but it also triggers a costly reset clause on a deal with Singapore state investment agency Temasek. Since December, the Singapore entity has injected approximately $5 billion of capital into the bank, but with a caveat. The reset clause demands that if within 12 months Merrill were to issue new stock at a price below Temasek's initial investment level of $48 per share, the bank would make up the difference. Once all is said and done, this will likely prove a very costly deal for Merrill Lynch.

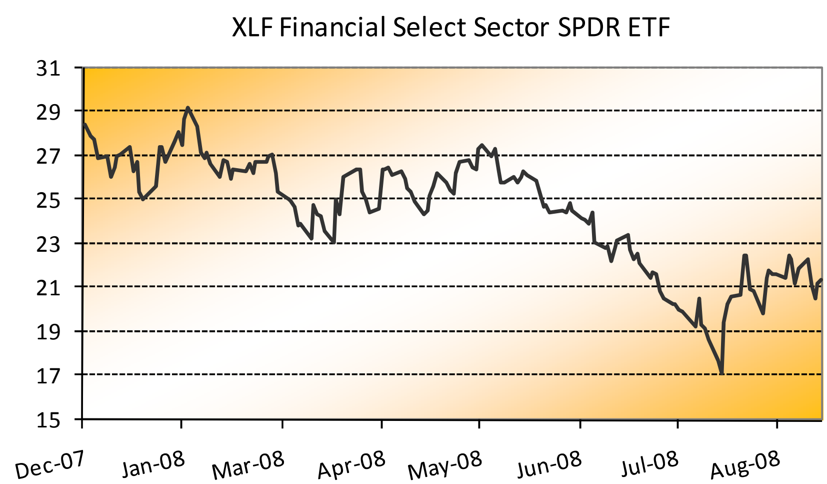
As Good As It Gets (for now)

On a positive note, this move signals that some financial institutions are willing to swallow some bitter medicine to purge their balance sheets. Although, these types of transactions can be costly in the short term, their longer-term benefits often can be significantly positive for the markets. In an environment reeling in uncertainty, these mark-to-market transactions (once completed) begin to reveal a true market price and help provide validity to the dialogue regarding total write down amounts. In aggregate, total losses attributable to the subprime crisis have now reached over $500 billion. This hurdle was leapt on August 12 after UBS said it wrote off another $5.1 billion in assets tied to U.S.

mortgage-backed securities, and $900 million to cover its buyback of auction rate debt securities. These assets frozen in supposedly-liquid auction rate securities have introduced yet another layer of losses, and the UBS deal is just the tip of the iceberg. New York State Attorney General Andrew Cuomo continues to pressure a list of major banks, including Morgan Stanley, JP Morgan, Merrill Lynch, Wachovia and Citigroup, to buy back failed auction rate securities from investors in New York state or face litigation. Given his success thus far, other states will likely follow suit extending losses for this particular branch of the credit crisis into the tens of billions of dollars. Although these write downs would provide additional pain to the battered banks, it would also provide another valuable data point for analyzing the total cost of the crisis. Whether or not the total financial losses from the crisis exceeds the $1 trillion number estimated by the International Monetary Fund in April, 2008, actions taken by the banks to clean up their balance sheets helps re-instill confidence that our financial institutions are moving through the crisis.

Analyze This

More than a year into the crisis, we have seen earnings for financial companies go into freefall. Profits for 7 of the other 9 (non-Financial) S&P sectors actually beat estimates for the second quarter of 2008, but in aggregate earnings for S&P 500 companies fell -23% under the weight of Financials. At the bottom of the barrel were Bank and Brokerage stocks, which have suffered a year-on-year profit decline of -94%, according to Bloomberg.



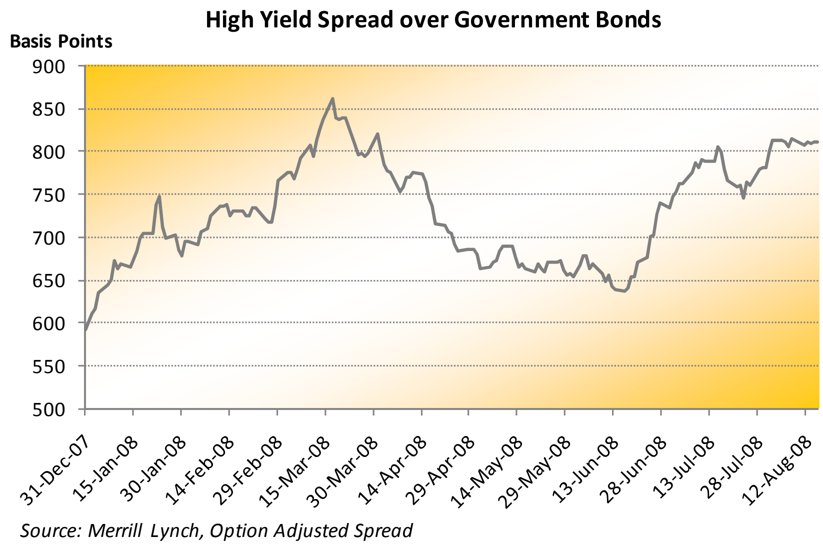
Source: Yahoo! Finance

Financials have also posted the worst sector total return year-to-date. The sector has fallen -27% through August 15, despite a +23% rally from its low on July 15. The rally was fueled in part by the announcement that the government would not allow Freddie Mac and Fannie Mae to fail, as well as by a new rule which prohibited so-called naked short selling[1] on a group of 19 financial stocks which included giants like Freddie, Fannie, Bank of America, Citigroup and Lehman Brothers. Short sales fell 78% in the first week the rule took effect, an apparent favorable shift in sentiment toward the sector. Investors did find other ways to short these securities, however. Short interest[2] on an ETF tracking the S&P 500 Financials sector rose 13% in the same period, while open interest on put options on the same ETF climbed to a near record.

[1] Naked short selling means selling a security without first borrowing the shares to cover the sale.
[2] "Short Interest" is the number of securities that have been sold short but not yet repurchased.

Risky Business

Generally speaking, we believe that a recovery cannot be sustained until an appetite for risk returns to the markets. Currently, traders are afraid to enter the market for fear that it will be even weaker in the future as banks continue to offload securities at cut-rate prices. Despite the Federal Reserve maintaining a fed funds rate of 2%, lending rates are still increasing. The 30-year fixed rate mortgage is currently at 6.4%, while six months ago it was only 5.8% despite the fact that the fed funds rate then stood a full percentage point higher. Corporate bond yields are showing a similar pattern. While the past week was one of the busiest in months for corporate bond sales, these issues came at record yields over benchmark rates for financial companies. Citigroup sold $3 billion of five-year notes at the highest spread over U.S. Treasuries since 1998, and AIG, the biggest U.S. insurer, sold $3.25 billion of 10-year notes at more than double the spread offered on similar debt in December. Clearly investors are still demanding a hefty premium from these at-risk companies.



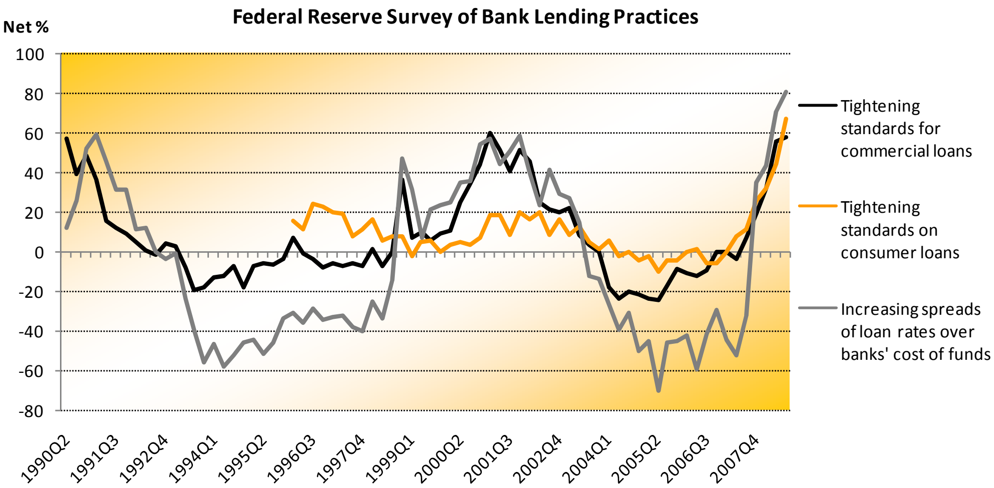
Source: Merrill Lynch, Option Adjusted Spread

As we have mentioned in previous publications (please see *"Credit's Cheap, But It Ain't Easy,"* Feb. 7 2008 and *"The Halftime Report: 2008"*, July 18, 2008), we believe that a narrowing of credit spreads will be a good general signal of renewed investor confidence. At this point, risk premiums once again are trending upward.

Trends in money market funds indicate that investors continue to shy away from the risk of equities. The Money Fund Report stated that assets in money funds topped a record $3.5 trillion last week, bolstered by a net $22.4 billion gain in the seven days ending Tuesday August 12. These assets are chasing yields that are not even keeping up with inflation. Money Fund Report Averages show that the seven-day average annualized yield on taxable funds is now 1.84%, down from 4.76% a year ago. Assets in money funds that restrict their holdings to U.S. government securities, and avoid the credit risks of banks, are up 19% since January 1, compared with a 14% increase in assets overall. This is a move that we have made at Miracle Mile Advisors as well to ensure the safety of our clients' cash positions.

Coming to America

We believe that until there is resurgence in securitization, borrowers will face tight credit standards and rising lending rates. In the first half of 2008, Thompson Reuters reports that private securitizations totaled only $131 billion, down 87% from the $1 trillion reached in the first half of 2007. Banks need to be able to repackage loans and offload the risk from their balance sheets in order to free up capital and extend additional credit; however, buyers of these assets are extremely risk averse given the credit quality misalignments of the credit bubble. As a partial remedy, Treasury Secretary Paulson is encouraging banks to issue "covered bonds," which are securities backed by assets as well as the seller's promise to pay. Covered bonds have grown to a $3 trillion market in Europe since they were first designed by Frederick the Great 250 years ago to rebuild Prussia through debt backed by the estates of aristocrats and churches. This type of bond allows loans to stay on the issuing bank's balance sheet instead of passing through to the investors, thereby limiting investor risk. Bank of America, JP Morgan, Citigroup and Wells Fargo all have said they will issue these covered bonds, however the debt would still be backed by mortgages and banks that are declining in value.



Source: Federal Reserve

Back to the Future

At almost every point in market history, investors have tended to extrapolate the current scenario indefinitely. Remember when the U.S. was running a surplus and the big debate revolved around how the surplus money should be spent? On Wall Street, there was even a debate on what would become the benchmark in fixed income when the U.S. government no longer needed to issue Treasuries to finance the country's debt. Just like every other scenario, both good and bad, this too shall pass. There have been some steps in the right direction. The Fed recently announced that it would extend the emergency lending facility for banks until January 2009, signaling that they would continue to grease liquidity as long as necessary. Write downs such as the one described above by Merrill Lynch may be a step toward finding the market-clearing (albeit discounted) price for these assets and getting them off of banks' books. However, our overall conclusion is that there is likely more unwinding to come. We do not yet see a bottom in housing prices and access to credit facilities is getting considerably tighter. We believe that the lack of risk appetite for financial institutions will continue until there is more clarity on the depth of their balance sheet woes. In light of these circumstances, we believe that a defensive portfolio is still warranted, with a higher than normal allocation to cash and reduced allocations to U.S. and Developed International equities.

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