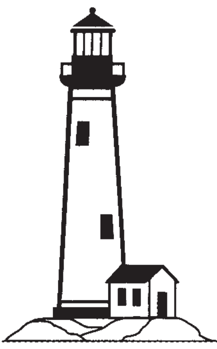


Lighthouse Beacon

A Guide in the 21st Century

Volume 10, Number 4 | Third Quarter Report | October 2008

Lighthouse Investment Commentary

The Cleansing of the Financial System Has Begun

In one week in September, virtually everything that could happen did happen.

During the momentous seven days beginning Monday, September 14, the United States government took over the country's two largest mortgage corporations (Fannie Mae and Freddie Mac) and put up $85 billion to rescue the nation's largest insurance company (AIG). That's not all. One of the remaining four major U.S.-based investment banks (Lehman) filed for bankruptcy protection, while another (Merrill Lynch) agreed to be taken over by a bank holding company (Bank of America). The remaining two top-tier investment banks (Goldman Sachs and Morgan Stanley) did survive, but only by agreeing to become bank holding companies with more stringent capital requirements and less ability to take risks.

The rest of the month was no less significant. The Bush administration announced a bold plan for a $700 billion bailout of financial institutions in an effort to restore liquidity and confidence to the economy. After significant debate in Congress, a revised plan was approved as government decision-makers sought to calm the increasingly jittery financial markets. The government also instituted tighter regulations over the financial markets, agreed to start providing insurance to money market funds and participated in the largest bank rescue (Washington Mutual) in the nation's history.

Meanwhile, evidence mounted of further deterioration in housing values and deceleration of economic growth.

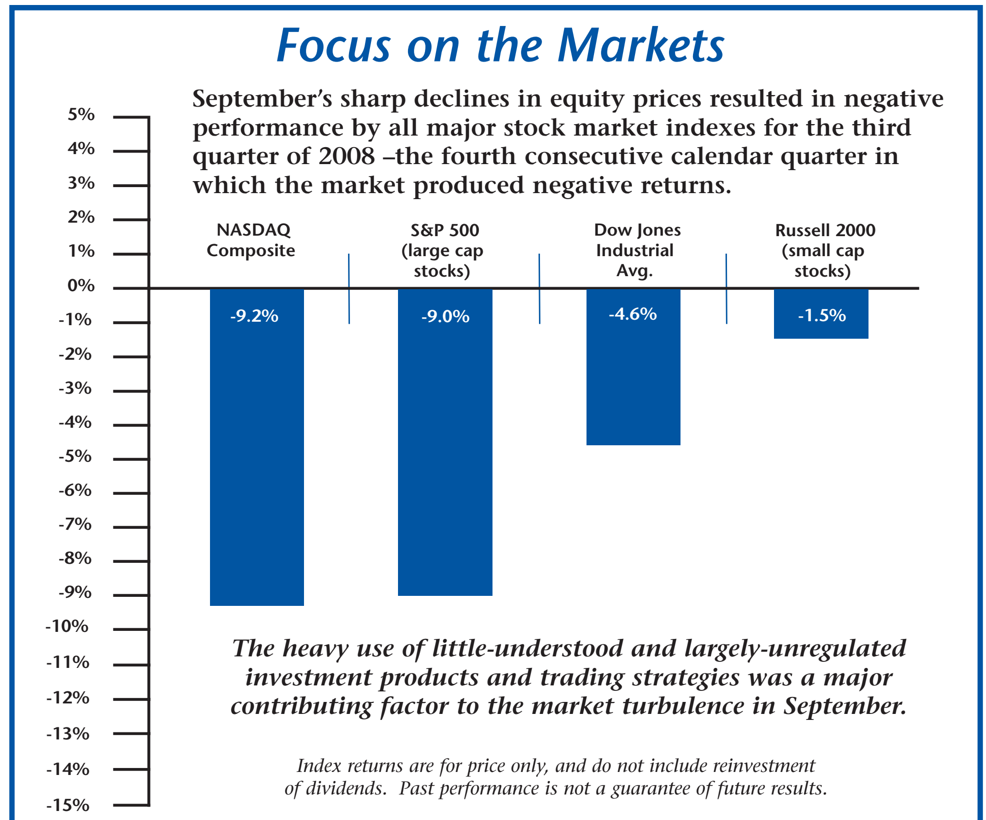
As all these events unfolded, investors grew more and more apprehensive, unsettled by the increasingly volatile capital markets at home and abroad. The American people alternately appeared angry about alleged corporate excesses, confused about both the causes and remedies of the financial crisis and fearful about their own economic security.

How do we keep all this in perspective? We at Lighthouse Asset Management remain proponents of the free market system, but we recognize there are times when the need for government intervention is unavoidable. It is clear that some rules and regulations are necessary for the maintenance and operation of a healthy free market system.

Much has been written and discussed about how the crisis appeared to start with the housing bubble and the subprime mortgage meltdown. We, however, believe not enough attention has been given to the real culprits responsible for the financial distress: the growing use of complicated and largely unregulated derivative products and trading strategies. With names such as collateralized debt obligations, credit default swaps, auction market preferred shares and naked short selling, these products and strategies were not clearly understood either by those who created them, by those who sold

Continued on back

Focus on the Markets



Index returns are for price only, and do not include reinvestment of dividends. Past performance is not a guarantee of future results.

The Lighthouse Beacon is a newsletter from Lighthouse Asset Management LLC, a registered investment advisor offering portfolio management services to individuals, trusts, retirement plans and small institutions. The views in the Lighthouse Beacon are those of the professional staff of Lighthouse Asset Management.

Continued from front

them, by those who purchased them or even by those who insured them. These instruments and strategies helped the investment banks, which had created them, gain enormous profits, especially when they borrowed money (used leverage) to speculate in them and trade in them. These investment banks, however, were among the biggest casualties when things began going wrong and a crisis developed. Just as the use of debt magnified their gains, it magnified their losses.

History has shown that it is always difficult to live through a financial crisis, especially one caused by the bursting of a speculative bubble. But these periods always lead to a cleansing of the excesses that caused them.

We believe we now are in the beginning phase of the cleansing of the financial system. Government intervention has moved from dealing with the crisis in a piecemeal process toward a comprehensive overhaul of the financial system in general and of mortgage finance in particular. To be sure, it will require time and some creativity and innovation, but we think the financial system will recover and the markets will stabilize. Confidence will return and the financial system will function efficiently again. As the excesses are removed, we believe investors also will face fewer risks than they have seen in some decades.

Change does not happen easily, especially when it is seen as a threat to the way that business has been done. However, we believe one of the less-discussed catalysts that will lead to healthy change is the transformation of the business models of Goldman Sachs and Morgan Stanley as they become regulated bank holding companies. Some will complain that this transformation is nothing less than the capitulation of the free enterprise system to government regulation and this inevitably will mean less innovation and creativity. We disagree, although we do believe the potential rewards from using excessive risk will be much lower. Instead, we see it as the start of a new era, with much higher standards of accountability. Age-old principles of responsibility and fiduciary obligation once again will guide the markets.

We think the rebuilding of confidence is beginning. We already have a greater understanding of what has led to the financial crisis, which is the first step in developing a comprehensive solution. Moreover, leaders are united in understanding that strong action must be taken.

It is important to note that the real economy has not collapsed, despite the meltdown of the financial system. American corporations are continuing to earn profits and, unlike in most previous financial crises, they tend to have strong balance sheets and be in solid financial shape. While the timing of a recovery is uncertain, we believe growth in the economy will start to revive.

We are approaching the point at which the markets will again see the creation of great value. This should present very real opportunity for those investors who remain focused on their long-term goals. More than ever, we think this is a time when the benefits of the deep experience and long perspective of private investment advisors will be more apparent than ever.

Lighthouse Guides

Q: What is short-selling?

A: The practice of short-selling stocks, especially of financial corporations, has been one of the strategies often blamed for exacerbating the crisis in the financial markets.

In its simplest form, short-selling a stock occurs when someone borrows shares of a company from their broker and then turns around and sells those borrowed shares. The person who borrowed the stock hopes the price of those shares subsequently will fall. If the stock price does fall, the original investor can buy back shares at a lower price and return the stock to the broker from whom he borrowed the original shares. The investor then can pocket the resulting gain.

Let's say you borrow 100 shares of Company XYZ from your broker. That stock currently is selling at $100 a share, which is the price at which you sell it in the market in a transaction totaling $10,000 ($100 multiplied by 100 shares). After you have sold it, the stock price falls to $80 a share. You go back into the market and buy 100 shares of Company XYZ at the lower price. That transaction totals $8,000 ($80 multiplied by 100 shares). You then return 100 shares to your broker. After all this has occurred, you have earned a profit of $2,000, less any trading or borrowing costs you have incurred.

The short-seller is essentially betting that the price of a particular stock will fall. This can be a very risky venture when the stock price of a particular company goes up rather than down. When the price goes up, the short-seller is forced to buy it back at the higher price and incur a loss. The short-seller is then caught in a "short squeeze."

One even riskier tactic is the practice of "naked short selling," which has been often blamed for intensifying the volatility in the market. That occurs when someone sells shares in a stock that he has not even borrowed, hoping to earn even more of a gain when the stock price falls. That exposes the investor to even more risk if the share price does not fall and the short-seller is required somehow to deliver the shares he has agreed to sell. Naked short-selling has been banned in most major foreign markets and the SEC recently took steps against the practice in the U.S.

For information, please call or write us or visit our website at www.lighthouseasset.com.

James R. McCall, CFA, President
343 Washington Street
Newton, MA 02458
617-332-1203
lighthouseasset@gmail.com

Dana P. Blake Jr., Executive VP
85 Eastern Avenue
Gloucester, MA 01930
978-282-8285
ibis22000@yahoo.com

Frank H. Gorke Jr., Senior VP
6573 Marissa Loop
Naples, FL 34108
239-514-7240
fgorke@aol.com