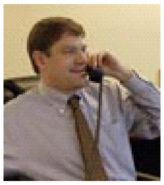
October 2, 2008



William A. Harris, CFA
Portfolio Manager

After the Fire

On a conference call in the midst of September's crises, PIMCO co-chief Mohamed El-Erian observed, "The unthinkable has become thinkable." More than that, we'd say, the unthinkable has come to pass.

I'll summarize what you already know: In just over two weeks, pseudo-federal agencies Fannie Mae and Freddie Mac failed and became federalized in fact; Lehman Brothers tried blustering its way to favorable terms of survival and wound up in Potter's Field; Bank of America's largesse spared Merrill Lynch a similar fate; AIG, as the master domino in a potential chain of rolling catastrophe, won unprecedented federal protection; the Reserve Primary Fund – the original warhorse of the money markets – collapsed spectacularly; and Washington Mutual managed to slink into oblivion quietly indeed for the largest failure of a bank or thrift ever (perhaps the unthinkable had become, by then, ho-hum).

Which brings us to now, as we stand (some would say teeter) on the threshold (some would say precipice) of the unknowable if not any longer the unthinkable. Of course – and this is important to recognize – the future has always been unknowable; it's just that it used to be easier and more comfortable for us to tell ourselves otherwise. This is another way of saying that, as much as we at Allen Capital and Allen Trust might like to have a crystal ball, we don't, any more than did the captains of the aforementioned crack-ups. We do, however, hope to keep our spectacles from beading up with the damp of popular panic or being fogged over by the hot air blowing out of Washington. It is these two latter dynamics – financial panic and its dismal byproducts, legislative hair-pulling and half-baked give-aways – that I'll now address.

When regarding it in the abstract, it's easy to dismiss panic as an indulgence of meeker souls or weaker minds, but when you actually run up against it, panic is an indomitable beast. Facing the trampling herd, all we have to fall back on is discipline: cleaving to basic principles of valuation and acting accordingly, which can demand buying into some of what others are overeager to get rid of. To do well for you in the long run, we must in the short run be willing to be seen as wrong. Of course, this discipline goes by another name: looking stupid, or at least taking that risk. It is no fun whatsoever, but it's necessary if we're to have a chance at outperforming on your behalf.

As for the second dynamic, where the financial and political realms intrude on each other, the best that we can reasonably hope for is that intervention will break the accelerating spiral of failures – that central authorities will be able to exert some control over the pace of deleveraging and in so doing, truncate the more perilous paths down which bad news can ramify. Whatever set of measures ends up getting passed will be oriented more toward process than fundamentals. The fundamentals – too much credit that shouldn't have been extended, too much debt that shouldn't have been shouldered – will remain much the same, and they will keep weighing on prospects for recovery.

We regard ourselves not as teetering on a precipice, but as having survived in a landscape rushed over by fire. Though familiar reference points are gone, forage looks scarce, and the cold and wet of recession are on us, we're still here and still working to build. There are going to be more challenges aplenty, but discipline will see us all through.

William A. Harris, CFA