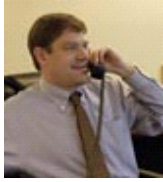




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## Complacency Undone, Liquidity Becomes the Prize

With the S&P 500 (which so recently celebrated its recovery past 2000's highs) having given up some 9% over the last month and long corporate bonds down 1.2% on the year, I start this month's letter by stealing wholesale from my March letter, which describes some of what's been knocking the markets about lately:

*If a single cliché embodies the market economies of the last half decade, it's this: "A world awash in liquidity." Gosh knows, I've uttered such words myself. But when a phrase becomes accepted as paradigmatic, as this one has, its days are numbered.*

*... the post-millennial sources of cash have been increasingly financial rather than productive. By this I mean that more of the liquidity pumping into the markets of late has originated not from truly generative processes (physically transformative or value-adding) but from mutual consent across nations and institutions and individuals, namely a persistent comity of willing financiers abetting willing investors by ever more finely engineered and complexly structured instruments.*

*This gets to the ability of the marginal bidder to fund his purchase. Increasingly it depends on the willingness and ability of a financier. What happens when the financier is no longer so inclined, or has imploded or been delisted? What happens if comity falters or complexity fails?*

*Well, the system locks up. Liquidity itself – so cheap of late – becomes the prize.*

This summer, the comity between lenders and borrowers has faltered, complexity in some conspicuous instances has failed, and liquidity, no longer cheap, has become dear indeed. A new

dynamic owns the moment: leverage + complexity + illiquidity = pain (if not annihilation).

But has the system "locked up"? For many individuals and institutions, it has. Homeowners facing mortgage rate adjustments to levels they can't support are finding themselves unable to refinance and would-be home buyers have felt the earth move beneath them as underwriting standards (on holiday so long) have tightened to the point of exclusion. Bear Stearns and Goldman Sachs have poured billions into hedge funds whose PhD-engineered leverage and exquisite tuning have betrayed them (oops). Dozens of mortgage companies have been shuttered. Major new bond issues have fallen back onto the books of their underwriters. And now even prime mortgage REIT and institutional money market funds are admitting temporary insolvency, unable to scrape up enough cash to fund scheduled distributions or meet redemption requests. Those who had taken liquidity for granted are now facing the most elemental financial risk, that of *needing cash and not having it.*

Central banks here and abroad are stepping in as lenders of last resort, pumping tens of billions of dollars, euros and pounds into the capital markets to stave off flat-out panic. Thus far they've been successful, though whether they can keep all the air from running out of a torn credit balloon remains to be seen.

Have your Allen Trust and Allen Capital Management portfolios "locked up"? No! We've been steering clear of complexity, leverage and low quality, and we've been favoring liquid assets (i.e. those readily converted to cash without having to significantly discount price) such as high quality bonds, short term notes, and blue chip large cap stocks. Indeed, we plan to be able to pick through other investors' wreckage and buy at values better than we've seen in a long time.

So while popular anxiety remains high, we welcome the prospect of new investment opportunities. Don't hesitate to check in with us.

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