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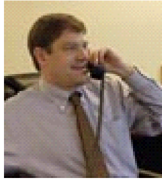

William A. Harris, CFA
Portfolio Manager

The Genie's Lamp Goes Missing

The genie, or Djinn, is a staple of Middle Eastern fables and Disney movies alike, a demon who, whether good or evil, typically unleashes results that confound mortals' intentions. A common theme is that friends or loved ones of the genie's master bear the brunt of the havoc. We'll come back to this in a moment.

Easy credit has been a hallmark of the last few years: No matter how farfetched your reasons to borrow, the jolly Credit Djinn would clap his hands and make it so. Jollity gave way to outright drunkenness, however, and the clapping became furious and the "making it so" ever more frantic, until the realization suddenly took hold this summer that collateral's valuation and liquidity do indeed matter. A moment of clarity, however late! We seem on the verge of learning a hard fundamental lesson: credit should never be mistaken for cash. Every fable needs a moral.

What can mitigate the damage? Central banks must choose whether to bail out the profligate, or to let them grapple with risky outcomes and fail or survive as they may. Which brings us to the notion of moral hazard, the financial concept that relieving investors of risk's downside actually redoubles recklessness and invites new crises.

Central banks globally injected almost $400B in credit in August in an effort to stave off systemic crisis (as distinct from economic crisis – the world economy remains robust). Though the long-term consequences are unknowable, as a tactical maneuver, this made sense. In particular, the Bernanke Fed's lowering of the discount rate on August 17 was shrewd – by availing liquidity *at a penalizing rate* (the discount rate still exceeds the Fed Funds rate), the Fed squelched a budding panic without inviting moral hazard. Anyone borrowing at the discount window still had to pay up for the privilege. Tactical success achieved, however, a strategic challenge awaits.

The Fed governors meet next week. Moral hazard will be part of their agenda, if not its headlining item. Our initial opinion is that for capitalism to serve the greater good (and we believe it does), the forces of destruction must be allowed to bring down rickety or purposeless constructs (and we believe much of Wall Street's "product" of late qualifies as such); this warrants keeping rates as they are. Or so goes one side of the argument...

The other side of the argument is that the Djinn's maelstrom is tearing over to Main Street, moving from the financial system to something broadly, solidly economic. While this particular Djinn's master (Wall Street) may be frustrated that he wasn't careful enough in watching what he wished for, other people are the ones to suffer. Though hedge fund managers may forego fees as lofty as they'd hoped for, and private equity may retreat from LBOs which would have yielded enough for the dealmakers to retire on, plenty of Americans are going to be losing their houses, their jobs, their hopes of forging ahead in a world where the echoes of credit's collapse will resound a long time. This latter prospect will dominate the Fed's decision, and in all likelihood they'll start dropping the Fed Funds rate in hopes of forestalling that scenario. Economic reality will trump economic morality, and maybe it should.

A rate cut will intend to restore growth and stability. But just as the Fed's steady hikes from 1.00% in 2004 to 5.25% in 2006 did little to stopper an overheating, three-sheets-to-the-wind Credit Djinn back into his lamp, so can one argue that reductions now are unlikely to make the sot retire and behave. More to the point, after a years-long bender, can anyone even find the lamp?

I don't envy the Fed governors, standing lampless as they are. For what *does* one do with a morning-after Credit Djinn, lolling about bleary and unshaven, pockets turned out... yet perhaps with his powers stirring and rousing him again to some unforeseen mischief?

Referring now to an "aftermath" is premature. Our story's moral may yet await unveiling, and meanwhile hazard will obtain.

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