

April 2008

The Waiting

What a week! Last week, I got little sleep. And, it wasn't due to the normal interruptions that sometimes come with having three young boys and an 18 month-old daughter. Last week, my mind was absorbed by the crescendo of the many incredible developments in the financial markets. It seems that sub-prime challenges together with declining real estate prices and a pending economic recession have finally led to a crisis of confidence in our financial markets.

This crisis has been felt in virtually every market around the world. Clearly, the US stock market is down significantly this year. In the bond market, it has been a rout. With the exception of US treasuries, no sector has been spared. In fact, virtually every sector, including asset-backed securities, agencies, corporates, mortgages and CMBS, has traded at or near historic wide spreads to treasuries. Furthermore, a number of derivative securities in these sectors and many credits such as Bear Stearns and CIT have lost considerable value. Thus, month-end pricing will be difficult for many bond managers and for the Index in general.

As a rule, we do not invest in derivatives. In addition, we avoided both Bear Stearns and CIT in our bond and stock portfolios. However, nobody can predict the next challenging situation. As for month-end pricing, we leave that to the pricing services. In our history, we have always used the values provided by our pricing service.

All last week, I was glued to both CNBC World and Bloomberg Asia into the wee hours. The last time this happened was back in 1997, during the Asian Contagion. Back then, the currency problems "over there" wreaked havoc on our financial markets here. This time the overseas business reports were about our problems "on the home front." The news channels reported on the global response to co-coordinated efforts by our government institutions to restore confidence in our financial markets.

As expected, the Fed has taken the lead in restoring market confidence. They have implemented many unconventional measures to avert a complete financial crisis. Earlier in the year, the Fed creatively increased liquidity in the banking system and implemented a surprise intrameeting cut in the fed funds rate. This month, they expanded unconventional liquidity measures, started swapping government collateral with primary dealers for agency-guaranteed and private label mortgages, cut the fed funds rate 75 basis points, approved a \$30 billion loan to engineer a takeover of Bear Stearns and created a lending facility for primary dealers. In addition, the government is cutting the capital requirements of FHLMC and FNMA and is expanding the buying capacity of the FHLB's in an effort to support the MBS market.

In my January letter titled "So Much for Goldilocks," I wrote about attractive opportunities in the bond market. Clearly, I was early as credit spreads have widened further. However, the conclusion in the letter still holds true. Looking at historical

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yield spreads over treasuries on a ratio basis as well as measuring value on a breakeven basis will help identify opportunities in the bond market.

Using this approach, the best high quality fixed income opportunity is with agency-guaranteed mortgages. Mortgage spreads over treasuries are at or near 300 basis points. These are levels not seen since the mid-1980's. Back then, the mortgage market was a new and inefficient market which justified the wide spreads. Today, we have a mature market where buyers have plenty of information including prepayment history, prepayment models, geographic data, servicer information, credit scores, loan data, etc. With spreads at 300 additional basis points, they are VERY attractive!

To quote Tom Petty, "the waiting is the hardest part!" It may be some time before the Fed's efforts finally restore market confidence. But if we wait for final confirmation, numerous opportunities will surely pass us by. Thus we have already been changing our bond portfolios to take advantage of the current situation. First, we have generally neutralized both our duration (interest rate risk) and our yield curve exposure as we expect treasury yields to generally rise with short rates leading the way. Second, we will continue to significantly underweight treasuries in favor of adding agency-guaranteed mortgages and high quality corporate bonds.

It's hard to imagine that the next few weeks will be as challenging and as unpredictable as last week. But we at DHJA are prepared for sleepless nights if the market continues this historic and extremely volatile behavior. And, we will do the necessary work and analysis to protect our clients' funds while looking for safe, high quality, investment opportunities in which to invest. As for more of Tom Petty's classic:

*The waiting is the hardest part
Every day you see one more card
You take it on faith, you take it to the heart
The waiting is the hardest part*

The hardest part for us is "the waiting" for market confidence to be fully restored and for credit spreads to return to normal.

On a more personal note, by the time you receive this letter we will have already celebrated the wonderful career of our good friend and partner Bob Davis. Bob's investment career goes back almost 40 years. Together with Jack Hamilton and Alfred Jackson, Bob founded DHJA in 1988 with little more than his son's college fund money and a dream. While we look forward to his continued wisdom as a shareholder in our partnership, we will certainly miss the many daily routines together. And, as he enters retirement, we want to thank him for the investment lessons, the great memories and the wonderful opportunity to continue his legacy. Thanks Bob.

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