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## The Credit Crisis & Our Investment Focus

With all the stressful news these days about the "credit crisis" and the serious risks it is bringing to our overall economy, I thought it might be helpful to try to simplify all of this a bit and thus reduce our stress. In doing so, one old quotation from my past keeps coming to mind:

"Neither a borrower nor a lender be;  
For loan oft loses both itself and friend,  
And borrowing dulls the edge of husbandry.  
This above all: to thine own self be true,  
And it must follow, as the night the day,  
Thou canst not then be false to any man."

This little quote from Shakespeare's Hamlet was one among many memorizations that all of us as Plebes (freshmen) at the Naval Academy had to recite on demand. It says a lot about how one should conduct their personal lives, but says almost nothing of interest to modern American business. That's because so much of modern business uses lots of continuous credit to smooth out their cash flows as they operate day to day.

The key players in this crisis are the banks because banks are the brokers that both borrow and lend and ultimately match money available to loan with borrowers who need the money to operate. Commercial banks borrow most of their money from you and me when we open checking and savings accounts or buy CDs. Investment banks, which lack the authority to offer consumer deposits, have to raise their capital by underwriting and selling securities. Up until about eight years ago, there was a law, called the Glass Stegal Act, passed during the 1930's, which enforced a legal separation between commercial and investment banks, mainly to protect depositors from the higher risk activities of investment banks. Once that law was terminated, a sort of free for all began in the credit markets as almost all banks succumbed to the temptation to chase the fat profits of the investment banks.

And so the bubble began to grow. Over time all the big banks became heavily invested in all sorts of exotic securities and would amplify their profits by borrowing money from each other to increase their ability to create new securities to sell. This borrowing to boost profitability is what's called leverage in the jargon of finance.

And just when the party was really going great and everyone was heavily borrowed with shaky collateral based on sub prime mortgages, the grim reaper on his black horse crashed through the doors and began to slay the party goers. The only exit was the door leading to reducing the leverage on their balance sheets and everyone tried to run through this door at the same time. So all the banks began trying to sell their assets at the same time and since there was little confidence in the value of these assets, there were essentially not enough buyers and the game became a crisis.

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and friend..."*

William Shakespeare  
(1564-1616)



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*“If you wish  
success in life,  
make  
perseverance  
your bosom  
friend,  
experience your  
wise counselor,  
caution your  
elder brother  
and hope your  
guardian  
genius.”*

Joseph Addison  
(1672 - 1719)

In a balanced financial system, there are many lenders and many borrowers. Thus in a large diversified economy, with the help of the banks and varying interest rates, everything runs smoothly. But, when all the banks are trying to reduce their debt at the same time, which is called deleveraging, there's no one in the private sector leveraging up to balance the market and the credit market grinds to a halt. That's why the Federal Government has had to step in as the lender/ buyer of last resort to inject enough capital so the banks can return to a position where the business of banking can get a fresh start and our economy will settle back down to its normal rhythm.

Meanwhile, hedge funds and other large institutional investors had been leveraging their investments by borrowing heavily, using their exotic investments as collateral. This kind of borrowing against your investments is called margin and is a very high risk for high reward strategy. One unique aspect of margin is that if the collateral loses value, the lender can demand that the borrower provide more collateral within 24 hours. If sufficient new collateral is not forthcoming, then the margin clerks have the legal authority to sell the existing collateral to reduce the loan balances to within acceptable limits. When this sort of forced selling happens, the easiest collateral to sell is what gets sold. That basically means they sell the large publically traded stocks and bonds first.

It was essentially a wave of this forced margin selling in October 2008 which made it the worst month in the stock markets in over 20 years. Not only did the stock markets get sold off across the board, but also the commodities markets, including gold, oil and copper were clobbered. Even municipal bonds were sold off. Only cash and short term Treasury securities were spared. The good news was that things appeared to be stabilizing a bit toward the end of the month.

While at Eagle Wealth Management, our heavy allocations to money market funds and our continued use of our disciplined sell strategy has helped to minimize our declines, we did experience some declines in the value in our energy sector stocks, mutual funds and municipal bonds. Now if the forced margin selling of quality collateral subsides, we should be in a position to redeploy our cash balances to begin rebuilding our portfolios for growth through careful selection of the soundest stocks and bonds.

We must still proceed with caution; however, because with the economy entering a serious recession, there will be pressure on corporate profits and thus a real possibility of further declines in stock values.

We will look both ways before moving forward because protecting client capital is still our principal focus in this investment environment.

Warm Regards

*Jette*

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