BEACON INVESTMENT MANAGEMENT
THE FRIDAY BRIEF
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The Snowball

We began the third quarter with most of the major stock markets in bear market posture, off 20% or more and we continued to decline from there. The Dow Jones Industrials dropped another 4.4% while both the S&P 500 and the Nasdaq fell over 9% more. From top to bottom the Dow lost a maximum of 27% while the S&P and Nasdaq toppled 30%. It was a quarter of ugly new records as the largest bank in US history failed and the largest US insurance company appealed for government help. Every investment bank on Wall Street is now gone. The nation's first money market fund the Reserve Primary Fund went below a dollar a share or "broke the buck" when Lehman defaulted on a large chunk of debt owned by the fund. The rates banks charge each other on loans reached record highs bringing those markets to a standstill. In fact, it's hard to find a market that has not been significantly affected by near and complete freezes in credit flows. And broken record or all broken records, by the end of a three-month ordeal Wall Street finds itself begging for help from a less-than-sympathetic US House of Representatives.

The roots of the problem of sub-prime lending go way back to the 70's when the government mandated that all Americans be given the opportunity to buy a home, whether or not they qualified. Mortgages and home ownership are part of the American dream. Our tax code going back to the 50's was written specifically to promote and facilitate home ownership. And it all works just fine as long as home prices continue to rise, homeowners keep their jobs, and their payments don't go up faster than their income.

Confidence in the financial markets was first shaken to the core in April when the government assisted the purchase of Bear Stearns by JP Morgan to forestall collapse and potential significant harm to the financial system. The little snowball innocently pounded out back in the 50's by April was a force to be reckoned with. The Fed and Treasury were able to divert the gathering mass around the financial system in April. As Bloomberg notes, not a single creditor suffered a default as the company was swept into JPMorgan with the help of a $29 billion Fed loan. Stock investors received about $10 each. The economy continued to grow in the second quarter of the year and stocks rose over 7%.

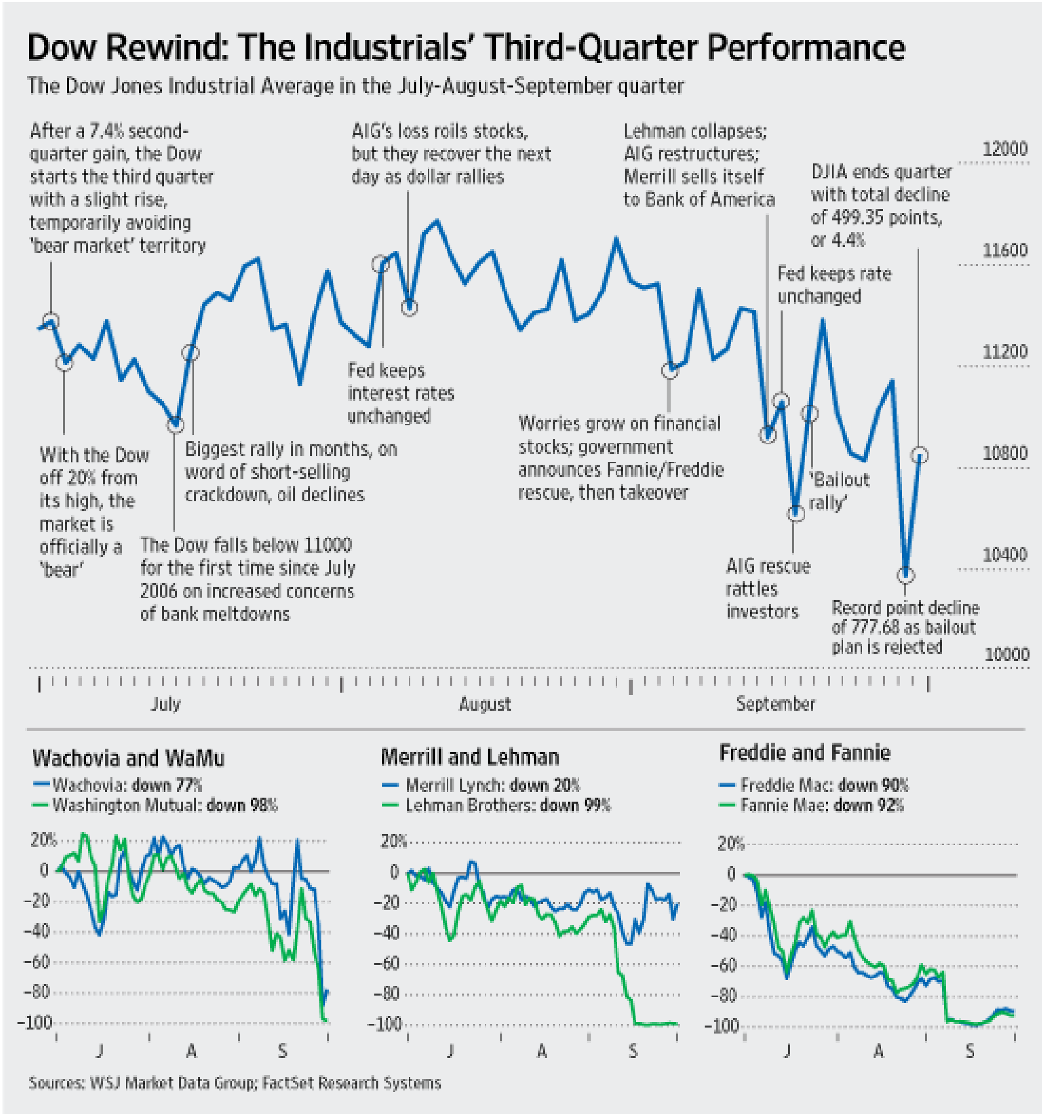
Rumblings and warnings continued as financial concerns reported record losses and credit markets grew less efficient. In early August AIG rocked the markets with their report of a $7.8 billion loss. That was on the heels of a $5.3 loss the quarter before. Then in early September the game plan changed. (See Dow Rewind on page 3) The snowball-dueling duo opted to retreat on Fannie, Freddie, and then Lehman Brothers, allowing shareholders to get wiped out. Confidence and expectations were bowled over. If Bear Stearns with $399 billion in total assets was too big to fail, surely Lehman Brothers with$639 billion in assets, possibly would be saved, but no. The deepfreeze was immediate. Capital markets quickly seized including a rout in financial stocks of nearly 10%, paralysis in the trillion dollar inter-bank loan market, and flight from money market mutual funds. Amidst the collapse

Bernanke and Paulson pulled the trigger on a plan they had been discussing for months (according to Bloomberg). It would be the largest public bailout in history. We now find ourselves, arguably our financial fate for the coming months, in the hands of politicians who are being asked to approve a bill that is widely unpopular among their constituents, the very people who will decide their political fate in less than a month. Don't you get the sense we are living in a moment of history? If our father's generation was the "Greatest Generation" what will be the legacy of their children? Are we headed for the Greatest _______ or the Greatest _______ or somewhere between?

I'd like to think that better days lie ahead. Former Federal Reserve Chairman Alan Greenspan said yesterday "trust will eventually reemerge as investors dip hesitantly back into the marketplace. From that point, history tells us, financial and economic revival sets in. I suspect it will be sooner rather than later." Warren Buffet has made huge investments in Goldman Sachs and General Electric in the past few days as he votes with his billions that things will get better.

At its core, we basically have a confidence problem. Banks don't trust one another, lending has all but ceased, and investors' confidence is shaken in almost every market imaginable. A large cleansing of bad debts has a better chance of working quickly than anything else according to most economists and experts. A 'cleansing' of that size requires the government to intervene. It's rarely a good thing when the government intervenes in the markets in a big way because the price tag is greater regulation.

Granted, there were huge regulatory lapses (lack of enforcement of regulations on the books). Rather my concern is that the reflexive action will be to over-regulate and add to an already burdensome body of rules and regulations that most well-run institutions follow to the letter. In effect it would hamstring American financial institutions just at the time that global competition is about to come fully into its own. We cannot afford to lose the kinds of financial innovation that will be required to finance the economy of the 21st century. The challenges ahead for the new President and Congress is to forge a more dynamic and fluid regulatory system capable of keeping up. This is the information age. It should be possible.



Just today there is evidence of some thawing. The Wachovia board of Trustees unanimously approved a merger with Wells Fargo for their entire operation, scrapping the government assisted merger of its banking units only with Citigroup. It is a good merger and the market resoundingly endorsed the news with a Dow rise of 150 points, a 74% increase in Wachovia stock, and a 5% jump in financial stock indices.

The bailout has the potential to restore some confidence in global markets. There is strong evidence that rate cuts are coming soon from the Fed, the Bank of England, the European Union and several Asian countries. These moves along with the huge cash already injected will eventually flow through the pipeline once the seized pumps begin working again. The problem is not liquidity, like it was in 1987, 1991, and 1998. We have a confidence problem. The pumps, the banks are frozen. No amount of money seems to thaw their intent hoard cash. The purpose of this bailout is to assure global financial markets that problem mortgages that have frozen the system are being removed. Perhaps gradually, the pumps will begin pumping again and the capital that moves the world's economies will begin flowing smoothly once again.