

Over the years we've seen markets rise on good news and even rise on bad news, but, never have we seen markets rise on uncertain news. Put another way, the market dislikes uncertainty even more than bad news. The first quarter of 2009 was a perfect example of this -- during January and February, stocks fell due to the questions surrounding the government's plan to stabilize and repair capital markets. Then, in March, as we began to get clarity on these programs, the market began a rally that has extended well into April.

The lesson is this: the market can be a very efficient mechanism when it has a framework to use. At the end of the day, the stock market is really just a giant discounting machine. Investors, as a group, incorporate all possible future scenarios and arrive at a market price. However, in the absence of a framework, investors will discount every possible negative scenario. Thus, in times of fear and uncertainty, equity prices often overshoot to the downside. It does not require "good" news to reverse this course. Rather, all that is needed is a modicum of certainty to soothe these fears and take some of the "bad" scenarios off the table. This is what we saw as the government began providing details of its stabilization plan in early March.

As you can see, these initiatives are extremely important for several reasons. First, they provide clarity, reassurance, and a framework for investors to use as they value stocks and bonds. More broadly though, these plans represent the blueprint to pull us out from our current economic situation. The breadth and depth of these plans are a clear indication that stabilizing our financial institutions is the foremost goal. This is an absolute pre-requisite to a lasting economic recovery and we believe this is a big step in the right direction.

We'll be the first to admit that keeping up with all the alphabet soup programs is both cumbersome and dry. However, their significance is unquestionable and thus we thought it would be helpful to highlight a few of the most vital and widely publicized initiatives. Of course, any time Washington is involved politics tend to creep in, but we will do our best to present the details without political bias. Before we drill down into specifics though, let's take a look at the five primary issues these programs aim to address:

- Restore confidence in the banking system by ensuring adequate capitalization
- Assess the health of financial institutions and clarify the values of securities on banks' balance sheets
- Unfreeze credit markets so consumers and small businesses can borrow
- Stabilize the housing market by preventing foreclosures and keeping mortgage rates low
- Remove "toxic" loans from banks' balance sheets so that banks can and will begin lending money again

During the first quarter there were many new initiatives and rule changes enacted, but we will highlight the six we believe had the greatest impact on the market. So without further ado, we turn our attention to the four programs and two rule changes that helped reduce uncertainty, provide a market framework, and serve as a spark for the recent market rally.

TARP – Troubled Asset Relief Program

Enacted on October 3rd as part of the Emergency Economic Stabilization Act of 2008, TARP is probably the largest and most well-known initiative. It is designed to ensure banks have adequate capital and it should also help unfreeze credit markets. To accomplish this goal, TARP provides banks with a capital injection in the form of a preferred equity investment. For unhealthy banks, this additional capital can be used absorb future losses related to bad loans. For healthy banks, this capital provides an additional cushion and frees up funds to be lent out. In total, \$700 billion was allocated to the TARP program. Roughly \$250 billion of this amount has been used for capital injections while the remaining funds will be used to help finance some of the other initiatives listed below.

TALF – Term-Asset Backed Securities Loan Facility

The TALF program was announced on November 25th, 2008 and is sometimes referred to as the “consumer bailout.” Through this program, the Federal Bank of New York will lend up to \$1 trillion to private investors to entice them to buy highly rated securities backed by student loans, car loans, credit card loans, and small-business loans. Reviving investor demand for these loans could help restore the flow of credit and translate into cheaper borrowing costs for consumers.

PPIP – Public-Private Investment Program

A coordinated effort between the Treasury Department, the Federal Reserve, and the FDIC, PPIP is designed to address the now-infamous “toxic assets” clogging up bank balance sheets. Toxic assets are loans (structured as securities) that are difficult to value and/or sell because of their one-of-a-kind nature and the uncertainty regarding default. They are being targeted because they force banks to set aside cash to absorb losses rather than lend cash out. Because they are difficult to value, it has been tough to find a price that banks and private investors can agree on. The PPIP attempts to resolve this by creating an auction for these securities. This allows for price discovery by the market rather than the government assigning a price and should serve as an important first step in the recovery process.

In these auctions, private investors and government funds will be used side-by-side to invest in these troubled securities. Using leverage, these funds have the power to generate \$500 billion in purchasing power and this may expand up to \$1 trillion in purchasing power. If the value and liquidity of these securities improve, this could be very profitable for both parties and should help bolster banks’ capital ratios while reinvigorating lending.

Mark-to-Market Accounting

Another angle being used to attack the “toxic asset” problem is related to accounting rules. Prior to the modification of these rules on April 2nd, these rules required banks to value these securities based solely on what they could sell them for in the current market. Because there were no interested buyers, these securities fell far below their true value and banks had to reflect additional losses in profit, despite the fact that they did not yet sell the security.

To conceptualize this, think of your own house. Imagine if you had a neighbor who had to quickly sell his/her house to avoid bankruptcy. In such a short timeframe and with the current real estate market, their home would almost surely fetch a value far below what the home is truly worth. Now imagine that after the sale, your bank comes to your door and tells you that even though you have no plans to sell your house, its value must be “marked down” based on your neighbor’s sale.

This is the problem banks faced with mark-to-market accounting, and on April 2nd, the rule was revised to better reflect the current environment. The main gist of the new rule is that instead of relying on distressed sales (such as your neighbor’s) to establish value, these assets can be valued using computer models based on the amount of income the asset will generate during its economic life.

Uptick Rule

Another rule that officials are revisiting is the uptick rule. While the vast majority of investors profit from stocks going up, some investors use a trading strategy that benefits from stocks going down. These folks have a bad reputation in the investment community not only because they profit from others’ gloom, but also because some have been known to fabricate rumors in an effort to better their position.

To control this cohort, the uptick rule was put into place in 1938, after a market panic was intensified by concentrated “short selling.” The new rule required a stock price to rise or “tick up” before the next “short selling trade” could be executed. On July 6, 2007, this rule was eliminated after the SEC declared it was no longer necessary. Fast forward to 2008, and short-selling had risen to record levels and “bear raids” had become commonplace in which short sellers would gang up in unison on a target. There is no way to be absolutely certain, but the lack of an uptick rule surely seemed to hasten the demise of several of this country’s largest financial institutions.

FIRST QUARTER 2009 ALPHABET SOUP

In the first quarter of 2009, Fed Chairman Ben Bernanke and outgoing SEC Chairman Christopher Cox both advocated for a reinstatement of the uptick rule. The suggestion has gained momentum ever since, and on April 17th, the SEC published a report in which it recommended several new proposals for a modified rule. The mechanics of how the rule will be implemented are still being discussed but the salient point is that this should significantly help protect stocks (particularly financials) from the undue pressure of short sellers.

CAP - Capital Assistance Program

The CAP program was first announced in February by Treasury Secretary Geithner and it has two key phases. First, the country's largest 19 banks will undergo a "stress test" to determine their health under "baseline" and "more adverse" scenarios. Second, banks in need of capital will be given six months to raise money privately. If they are unable to do so, they can accept another injection of capital from the government either by issuing new shares or converting previously issued preferred shares (from TARP) into common stock.

In order to protect the taxpayers' investment, several strings will be attached to these funds including restrictions on executive compensation, lobbying, dividends, and acquisitions. In addition, these firms will be required to participate in the mortgage modification program and demonstrate how they will increase lending. All banks with over \$100 billion in assets are required to participate and these results will be released on May 4th. The goal of the stress test is to restore confidence in healthy institutions, and help shore up the capital positions of weaker banks so they can resume lending.

A Spoon Full Of Sugar

These plans are certainly not flawless and they have undoubtedly received their fair share of criticism and debate. There is truth in these critiques and there will surely be unintended consequences. However, we have to remember that our financial system is in uncharted waters right now, dealing with incredibly complex problems for which there is no easy or painless solution. Perhaps it could be best summed up with an old saying:

"Like medicine, the test of its value is not in its taste, but its effects."

There was no single cause of today's economic woes and there is no single solution. While many pundits in the media are focusing on all the potential negative side effects, the reality is this: there is no magic wand and the government is being forced to choose between options that are "bad" and "worse." When Rome is burning, you don't debate the type of bucket to use or how much water to spray, you focus your efforts on putting out the fire. With the benefit of hindsight, we will surely look back and realize that not every program was necessarily the "optimum solution." Keep in mind, though, that not every program or rule change needs to be a cure-all. That is unrealistic. Rather, the government's actions will be deemed a success if they provide reassurances to the market that a) the administration takes the problem seriously; b) it will act aggressively to help solve the issues; and c) it will continue to communicate the details of a well-thought out plan. All these things help remove one of the biggest obstacles our markets face: uncertainty. As clarity increases, the market mechanism will once again have a framework to use, and we can hopefully set the stage for more rallies like the one we've seen since March.

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BOWLING PORTFOLIO MANAGEMENT LLC 4030 SMITH ROAD SUITE 140 CINCINNATI, OH 45209
(513) 871-7776 WWW.BOWLINGPM.COM

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