

The Financial Meltdown: Depression or Major Opportunity Ahead?

Fundamental and Psychological Errors That Led to the Panic

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Breakdown of Financial Fundamentals: The Clinton Era

- Weakening of the Financial System during Clinton Administration
 - Barney Frank and Democratic push for low cost housing - “chicken in every pot”
 - The role of then Secretary of the Treasury Summers
 - Repeal of the Glass-Steagall Act – since 1930s prevented banks from competing with investment brokerage firms
 - Prevented regulation of OTC derivatives (e.g. Credit Default Swaps) trading between financial institutions
 - Mortgagees’ incomes were often fraudulently overstated by mortgage companies
 - Poor quality Mortgage Backed Securities
 - yields were so high (>15%) that financial institutions couldn’t resist
 - Moody’s, Standard & Poors and Others
 - received large fees upfront to give MBS’s high ratings
 - Enormous leverage of capital
 - REITs and Investment Banks often leveraged poor quality mortgages up to 30-40x the actual capital invested
 - With such attractive returns bankers never bothered to “look under the hood”
 - Bankers assumed housing prices would go up indefinitely

Breakdown of Financial Fundamentals: The Bush Era

- The Bush admin accelerated the course by encouraging poor quality borrowers to purchase mortgages
- Greenspan kept interest rates exceedingly low and credit plentiful
 - Dollars flowed to Hedge Funds and Private Equity
- Result: enormous use of leverage
- The Fed under Bernanke and the Treasury under Paulson
 - Reassuring statements were made in mid-2007 that no government action was needed
- The lethal influence of the short-seller
 - The up-tick rule which was put in place after the 1929 crash was removed in 2007

Panic and Crash

- March 2008 – Bear Stearns levered 33 : 1
- Housing prices begin to fall
- Subprime mortgage index plummets to under 10 cents on the dollar
- At the eleventh hour (under the auspices of the NY Fed), J.P. Morgan buys Bear Stearns at \$10/share
- Fed guarantees \$28 Billion of Bear Stearns bad debt
 - Because of the interconnectivity of the financial industry, it was agreed that there was no other choice
- Inconsistency of Fed and Treasury action increases market panic

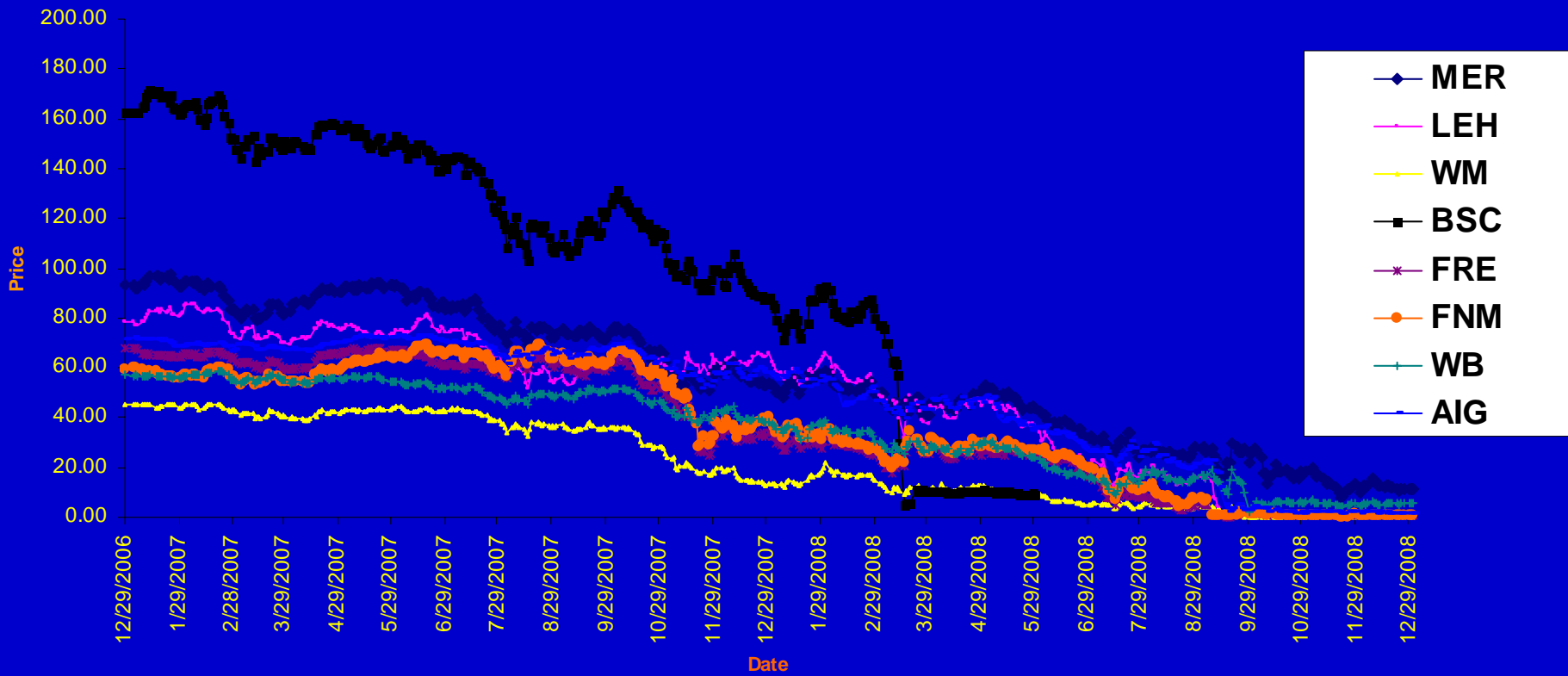
Panic and Crash: Fall of the Subprime Index



As evidenced by the ABX.HE.BBB- 06-02 Index

The Collapse of Financial Stocks:

Fall of Merrill, Lehman, WaMu, Bear, Freddie, Fannie, Wachovia and AIG

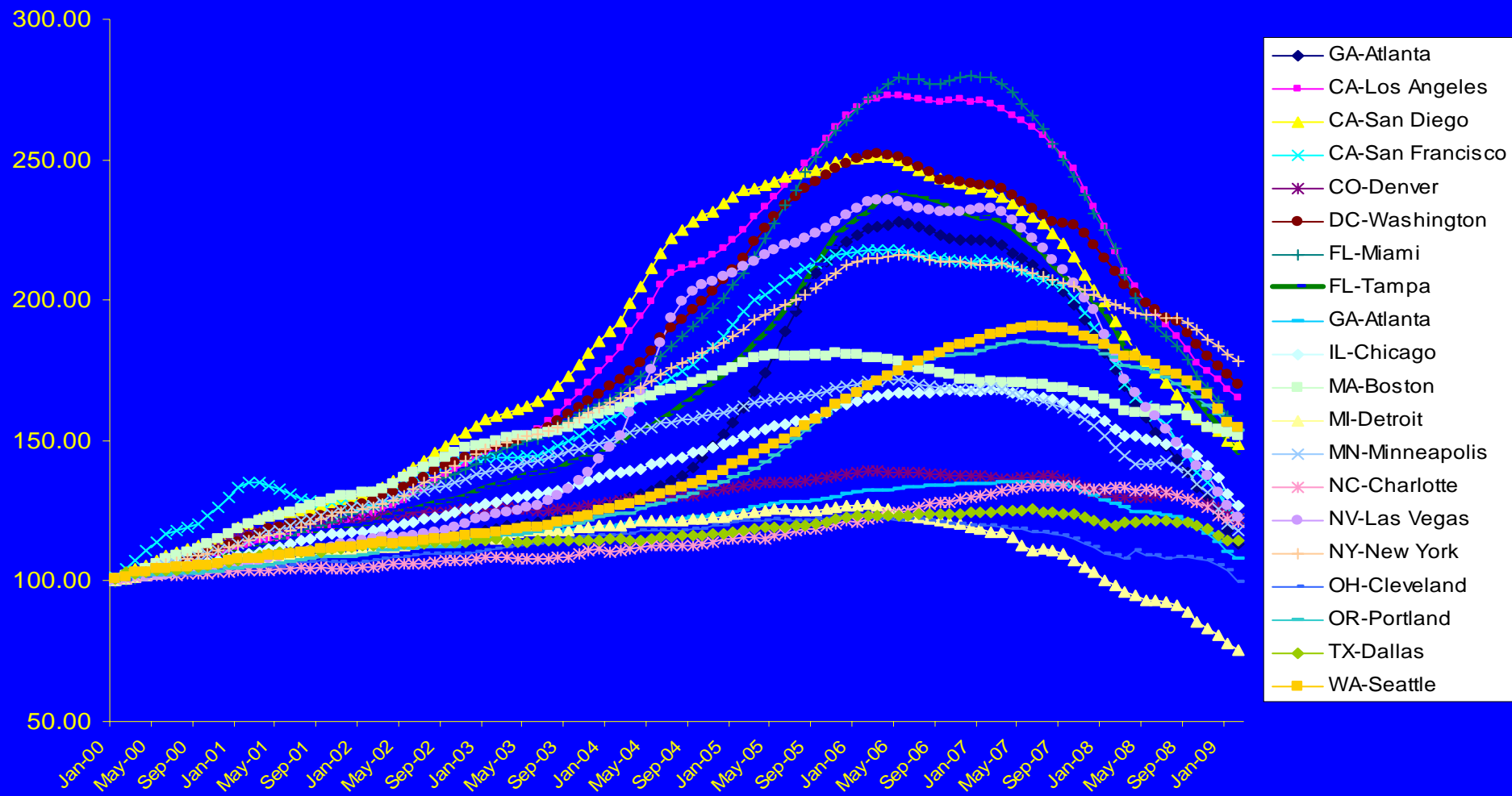


Panic in Financials 2007 – 2009

| | | <u>High Price</u> | <u>Low Price</u> | <u>% Drop</u> |
|-----|--------------------------------|-------------------|------------------|---------------|
| WM | WASHINGTON MUTUAL INC | \$ 46.15 | \$ 0.01 | -100% |
| FRE | FEDERAL HOME LOAN MORTG G CORP | 68.55 | 0.25 | -100% |
| FNM | FANNIE MAE | 70.57 | 0.30 | -100% |
| AIG | AMERICAN INTERNATIONAL GROUP | 72.97 | 0.33 | -100% |
| C | CITIGROUP INC | 56.28 | 0.97 | -98% |
| WB | WACHOVIA CORP | 58.80 | 1.25 | -98% |
| HIG | HARTFORD FINANCIAL SERVICES | 106.23 | 3.33 | -97% |
| BAC | BANK OF AMERICA CORP | 54.21 | 2.53 | -95% |
| MS | MORGAN STANLEY | 75.50 | 6.71 | -91% |
| COF | CAPITAL ONE FINANCIAL CORP | 83.84 | 7.80 | -91% |
| PRU | PRUDENTIAL FINANCIAL INC | 103.27 | 10.63 | -90% |

S&P/Case-Shiller Home Price Indices:

Drop of housing prices across 20 US Cities Jan 2000 – Mar 2009



From May 2006 through March 2009, the 20-City Composite Index dropped **-31%**

Panic and Crash: Bear Stearns Aftermath

- Fed and Treasury remain asleep at the switch
 - No preparation is taken for the financial tsunami that is approaching
- Housing prices continue to fall as increasing numbers of Alt-A and subprime mortgages default
- Banks, brokerage houses, REITs and other owners of mortgage securities begin to sharply increase reserves
- Reserves not large enough to see these institutions through the Crisis
 - The financial institutions become unglued

Panic and Crash: Demise of Fannie and Freddie

- Fannie and Freddie guaranteed nearly half the home mortgages in the country
 - Foreign governments that hold Fannie and Freddie paper begin to panic (particularly China and Japan)
 - June 2008 – Treasury Secretary Paulson announces that both institutions will be granted borrowings from the Fed
 - Lockhart echoes Paulson's statement
- September 8, 2008 - Paulson and Lockhart take an unexpected 180° shift in policy
- GSE's are placed under conservatorship
- Preferred and common shares drop over 90%

Panic and Crash:

Aftermath of Freddie and Fannie

- **September 15:** Lehman Brothers files Chapter 11, Bank of America agrees to buy Merrill Lynch, and AIG reportedly seeks financing from the Federal Reserve; the Dow Jones Industrial Average plunges 504 points.
- **September 16:** The Federal Reserve authorizes the Federal Reserve Bank of New York to loan up to \$85 billion to AIG, and the U.S. government takes a 79.9% stake in the insurance company.
- **September 19:** The SEC prohibits short selling in 799 financial companies for 10 business days. The U.S. Treasury agrees to insure the holdings of any publicly offered eligible money market mutual fund—both institutional and retail.
- **September 21:** The Fed allows Goldman Sachs and Morgan Stanley to convert to bank holding companies from investment banks.
- **September 25:** Bailout talks stall and cause electronic run on some banks; Washington Mutual fails, making it the biggest bank failure in U.S. history. Most of its assets are sold to JPMorgan Chase for \$1.9 billion.
- **September 29:** Citigroup agrees to acquire banking operations of Wachovia with FDIC sharing risks and receiving a stake in the company.

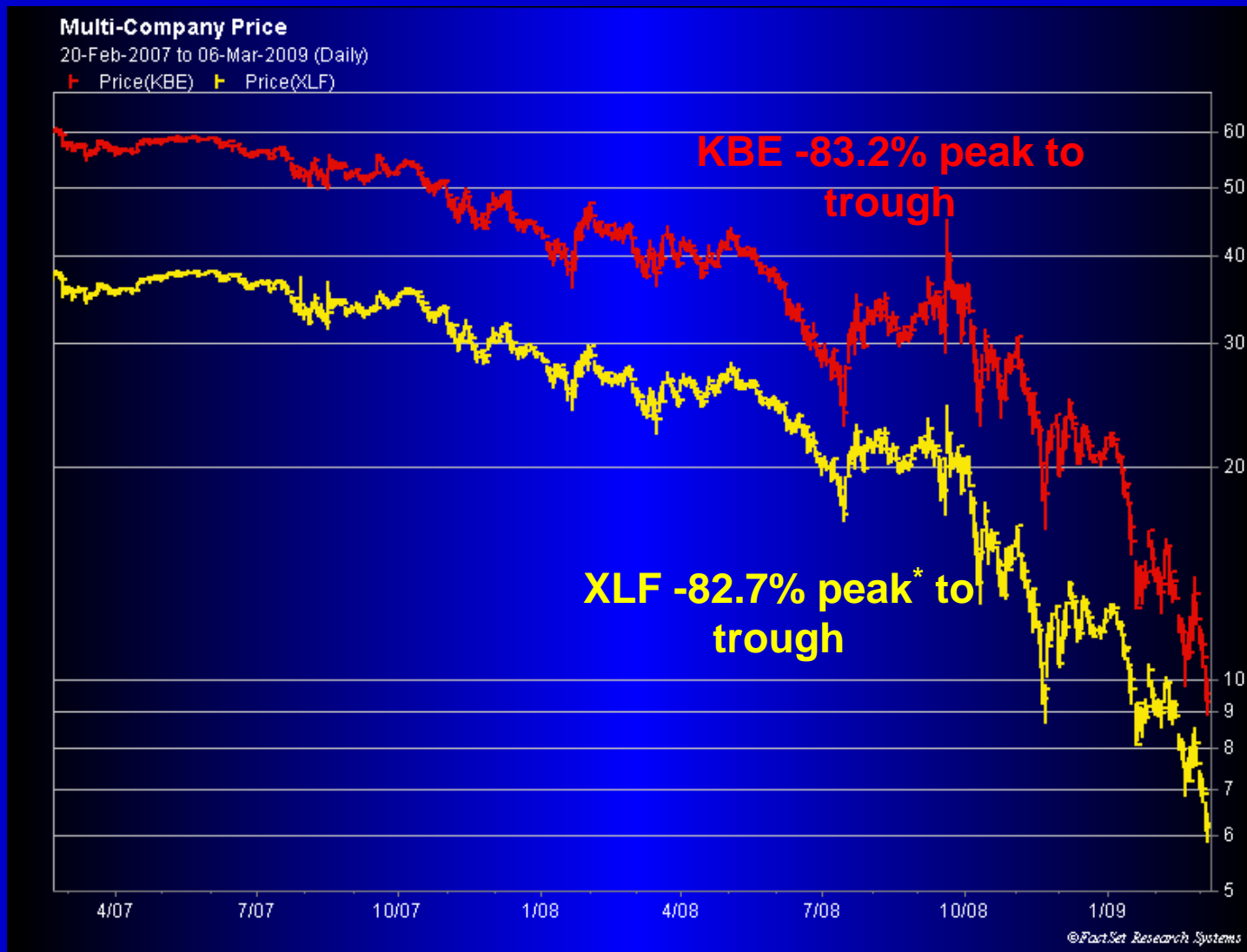
Panic and Crash

- Conservative ideology of the far right coupled with scare stories widely reported in the media, including the WSJ and the abandonment of the uptick rule
 - Stocks were driven to such low prices that they had no ability to raise capital
 - Ironically SEC chairman Cox, in a prelude to the lack of investigation of Madoff, refused to intervene despite being urged to do so by many financial experts
- Banks continue to drop sharply (KBE index falls nearly 90%)
- Paulson swings from a laissez-faire philosophy to actions that could best be termed socialist
 - Bailout plan presented to congress is not well thought out and only a page and a half in length
- Collapse worsens under the newly formed Obama Administration
 - Market continues to freefall due to murky plans provided by Geithner

Financial Indexes: KBE and XLF

February 20, 2007 – March 6, 2009

The Drop was almost as sharp as 1929-32, but condensed to 24 months



* - The peak for the XLF Index was June 1, 2007

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Panic and Crash: Global Fear

- The S&P 500 Index
 - From its high in October 2007 to its low in March 2009, the S&P 500 drops 52%
- The Dow Jones Industrial Average Index
 - From its high in October 2007 to its low in March 2009, the Dow drops 54%
- Worst market drop in both relative and absolute terms since the 1930s

The Worst Market Drop in Both Relative and Absolute Terms Since the 1930s

October 9, 2007– March 9, 2009



Looking to the Future: Market Outlook

The Negatives

- We are in the sharpest global recession since the 1930s
- Some would call it a moderate depression
- This is the first time in modern history that a complete collapse of financial markets occurred and credit was not available

The Positives

- Policy makers worldwide understand the potential deflationary threat and are taking action
- Progress in returning liquidity to the banking system domestically and abroad continues on an unprecedented scale
- Stress tests reveal that banks have successfully raised capital to appropriate levels
- Confidence continues to rise
- Rate of decline begins to stabilize in numerous economic indicators

Looking to the Future: Forecasting Markets Ahead

- Too early to call a new bull market; not too early to say the worst is likely over
- March – April '09: sharpest rally since 1933
- Stocks begin to double off their lows
 - Examples: GE, Bank of America, Citigroup
- Earnings forecasts, while still depressed, begin to rise
- We forecast earnings will gradually move higher
 - If the market concurs we should see stock prices advance sharply
- With trillions of dollars poured into worldwide recovery we should see the highest inflation since the 1970s – 80s
 - Devastating for bond markets, Treasuries will perform poorly
 - Keep your maturities short!
 - The worst investments of the last few years, Stocks and Real Estate, are likely to be the best performers in our opinion
 - Stocks typically fare well in inflationary or hyper-inflationary periods