Altamont Capital Management

Fourth Quarter 2007 Performance

"In investing, the return you want should depend on whether you want to eat well or sleep well."

J. Kenfield Morley

The U.S. stock market ended the year in a cloud of uncertainty due to seized-up credit markets and the rising fear of recession. These challenging conditions left many on Wall Street tired and fearful. Amazingly, each of the last two quarters ended well off its low and the stock market was up for the full year. However, the market's overall gains were trimmed by weakness in the last few weeks of December leaving investors with little more to show for their year long wild ride than in Certificate of Deposits.

The turbulent ride was caused by two major shocks: first a housing slump, which then triggered the second shock; tightening credit market conditions. These twin shocks roiled the markets, causing the U.S. bond and stock markets to constrict in the fourth quarter. The S&P 500 (a proxy for large stock performance in the U.S.) was down 3.3%. Though the mid-caps fared better, falling only slightly, the small cap sector did not fare well at all, falling 6.4% during the quarter. In fact, the fourth quarter decline in small caps was significant enough to erase all its gains earned earlier in the year. In contrast, large caps in 2007 gained 5.4%.

Fourth Quarter 2007 Benchmark Index Returns

	Fourth Quarter	2007 Returns
Large-Cap Benchmarks		
S&P 500 iShares	-3.3%	5.4%
S&P 500 Growth iShares	-1.6%	8.6%
S&P 500 Value iShares	-5.4%	1.9%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	-2.7%	7.8%
S&P 400 Mid Growth iShares	-0.8%	13.4%
S&P 400 Midcap Value iShares	-4.6%	2.4%
Small-Cap Benchmarks		
S&P 600 iShares	-6.4%	-0.4%
S&P 600 Growth iShares	-6.0%	5.5%
S&P 600 Value iShares	-6.9%	-5.7%
Other Benchmarks		
MSCI EAFE Int'l iShares	-1.9%	11.0%
MSCI EM Int'l iShares	2.8%	34.6%
Vanguard Total Bond Mkt Instl	3.1%	6.9%
DJ-AIGC Commodities iPath Tr	4.6%	15.5%

The real story in the U.S. stock market last year was growth, which trounced value stocks. Many of the value-oriented issues, such as banks and mortgage companies, had a tough year. Thus, the S&P 600 Small Cap Growth ishares generated a 5.5% return in 2007 while the value ishares fell 5.7%. The divergence was just as great for the Mid-cap S&P 400 ishares, with growth earning 13.4% and value only 2.4%.

In the foreign markets, emerging markets (for example: China, India, Brazil) triumphed over developed countries (England, Germany and Japan) during the fourth quarter and the year. Stocks in developed countries fell almost 2 % during the quarter but were up an impressive 11% for the year. The dollar continued to weaken during the quarter, which helped bolster the returns on most international investments. International emerging-markets were up 2.8% for the quarter and an astounding 34% return for the year.

The upheaval in the bond markets continued this quarter with the flight to quality bonds accelerating. As a result, Treasuries and highly-rated Corporate Bonds did well. The riskier bond offerings such as junk bonds, mortgage–backed bonds, or other collateralized debt obligations (CDOs) fell in value. The Vanguard Total Bond Institutional Fund, which is composed primarily of high quality bonds, was up 6.9% for the year with 3.1% of that return occurring in the fourth quarter. The Merrill Lynch U.S. High Yield Master Index, which is composed of lower quality bonds, fell 1.2% for the quarter but was still up 2.1% for the year. Riskier bonds underperformed, and 2007 will be remembered as the year that risk was repriced into the market.

Commodity futures performed well this quarter due to the continued surge in oil prices. The PIMCO Commodity Real Return Institutional Fund rose 9.3% in the fourth quarter, generating a year-to-date return of 23.4%.

Emerging-market short-term bonds (PIMCO Developing Local Markets) continue to perform well despite volatility in the fixed income arena. The fund was up 3% over the quarter and 13.2% over the year, primarily due to the declining value of the dollar against other currencies.

So What Happened and What Does It Mean?

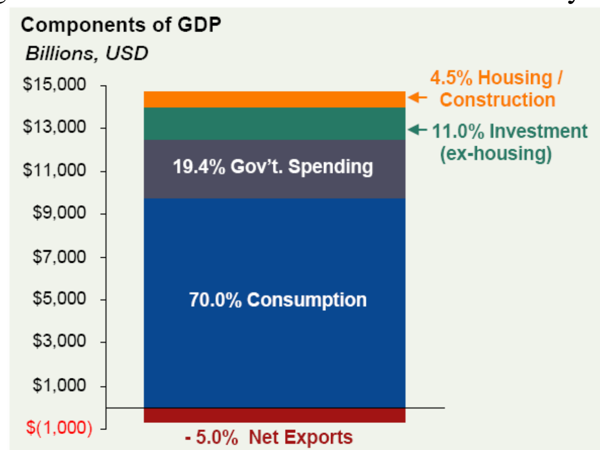
Without a doubt, investors will remember 2007 as the year that the housing market collapsed and triggered a credit crunch. The earnings of just about any company that was involved in homebuilding or lending were crushed, and resulting economic worries triggered stock declines for many consumer goods companies. Simultaneously, U.S. exports boomed, reaching an all-time high of 12.1% of GDP. Not surprisingly, companies with significant foreign-based earnings did well. Overseas stocks also delivered great returns, and as these economies continued to grow so did their demand for energy and raw materials commodities from China and other high-growth developing countries.

The last few weeks have been difficult for stocks as prices have declined substantially. The S&P 500 started the year at 1,467 and is hovering in the 1,300 as I write this column. With these declines, the markets are down more than 10% from their October 2007 peak. The markets have broken through many technical support levels -- this is true for every major index (Dow Jones, Russell, Nasdaq and S&P), which means that technical damage has been done.

The good news is that the Federal Reserve has finally woken up to the severity of the situation and is working diligently to respond to escalating economic concerns. On January 22, 2008, the Fed unexpectedly cut the fed funds rate by 75 basis points (0.75%) from 4.25% to 3.50% in advance of its policy meeting. The Fed has not cut rates in one stroke by such a large amount since 1982. In making the cut, the Fed cited the "weakening of the economic outlook and increasing downside risks to growth." This move was desperately needed to ensure market stability and sooth investor fears.

It appears that the combined impact of the housing implosion and the fallout from the structured finance debacle has pushed the U.S. into recession - or at least whole sectors of the economy are now in recession. How protracted the economic weakness will be and what its full impact on the markets are the new questions to be answered.

The key to an economic turnaround is consumer spending because it accounts for 70% of our economy (Gross Domestic Product—GDP). The falling housing market and the resulting tightening of mortgage lending have hit consumers hard, causing them to spend significantly less. Consumers who are more and more worried about the overall economy have triggered stock declines for many consumer goods companies.



A volatile stock market does not help consumer sentiment either. When you add rising unemployment to the mix, it is obvious that the U.S. consumer isn't going to go on a spending spree anytime soon. It will be tough to entice the consumer to start spending when it is difficult to borrow, and many are already heavily in debt. Until credit markets are repaired, the consumer won't start spending enough to cause a recovery,

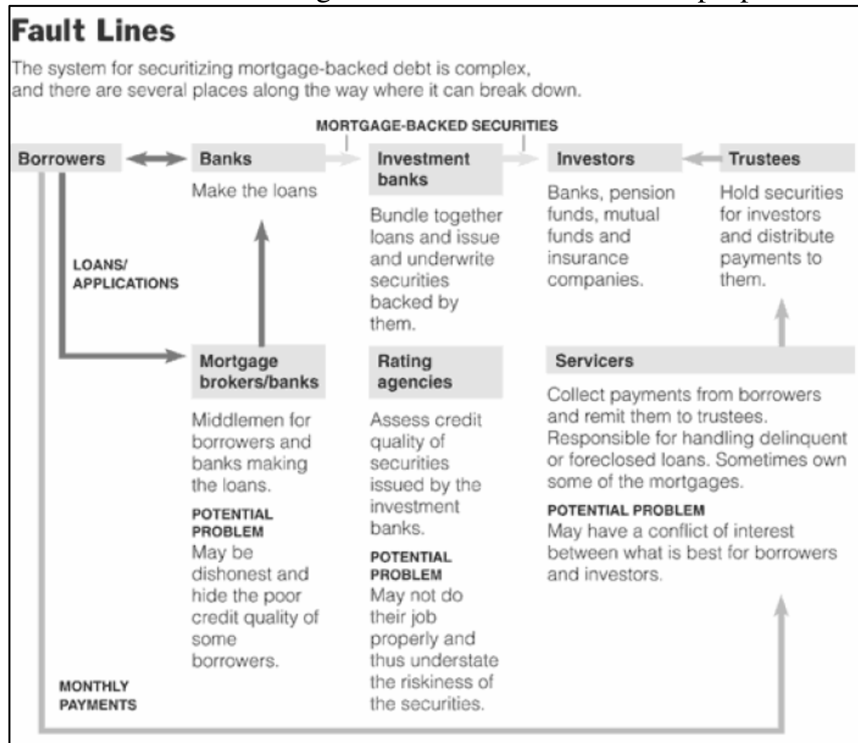
and businesses will curtail spending. If consumers and businesses aren't spending, that only leaves the federal government, a scary thought. Even the proposed fiscal stimulus plan by the President won't be enough to turn the tide. When credit becomes this tight, a recession is almost inevitable.

How did credit get so tight? Why are funds more scarce and underwriting criteria toughening? It all started with the mortgage-backed securities and how they are packaged and sold through our unregulated shadow banking system.

Mortgage-Backed Securities and the Housing Market

Most mortgages are not held by the lender who made them to you. They are pooled with others and sold to investors such as insurance companies, mutual funds, foreign banks and pension funds. A different company processes your loan payments. Yet another company represents the investors as the trustee. The very innovation that made mortgages so easily available, an assembly line process known on Wall Street as securitization, has caused our current problems.

The idea of pooling loans and selling them to investors dates back to 1970, but the practice has exploded in recent years. At the end of last year, $6.5 trillion of securitized mortgage debt was outstanding. In the last few years, securitization led to this explosion of bad loans because the agents writing the loans didn't care if they would ever be paid back. They made a fee by originating the loan and then sold the mortgage (passed on the risk) to another middleman who then passed it on to some anonymous investor. The incentive was to originate loans and to heck with proper underwriting (screening the borrowers to see if they qualified).



The process begins with the entity that originates the loan, either a mortgage broker or lender. The loan is assigned to a company that will service it (collecting borrowers' payments and distributing them to investors). A Wall Street firm then pools thousands of loans to be sold to investors who want a steady stream of cash from loan payments. The underwriters separate them into segments based on risk called tranches.

Once a pool of mortgages (trust) is sold, a trustee bank oversees its operations on behalf of investors. The trustee makes sure that the terms of the pooling and servicing agreement are met; this document determines what a servicer can do to help distressed borrowers.

By its nature, the complex design of mortgage securities creates unwanted difficulties, which are written to ensure that the middlemen make their profit with little to no risk. Almost nothing in this process is done in favor of the borrowers' interests. In fact, the agreements require that any modifications to loans in or near default should be "in the best interests" of those who hold the securities. Loan modifications are restricted which explains why many borrowers are having difficulty renegotiating their loans.

Fifteen years ago, the last time the housing market ran into stiff trouble, government-sponsored enterprises like Fannie Mae did most of the work pooling and selling mortgage securities. These enterprises readily agreed to loan modifications, but not so this time. In fact, it is in many cases impossible to determine who really is holding the title. This is a mess, and many more home owners will lose their homes, keeping the housing market depressed until well into 2009.

Why has the implosion of mortgage-backed securities been so destructive to the financial markets? The failure of mortgage-backed bonds has rippled through the markets, hurting financial institutions and the newer non-traditional banking system. This unregulated shadow banking system is comprised of a plethora of opaque institutions and vehicles that have sprung up in American and European markets over the last decade. They have come to play an important role in providing credit across the financial system.

Shadow Banking

These institutions, moreover, have never been part of the "official" banking system; they are unable, for example, to participate in Fed Treasury auctions. But as the credit crisis enters its sixth month, it has become clear that one of the key causes of the turmoil is that parts of this hidden world are imploding, sparked by the failure in mortgage-backed bonds. This in turn is creating huge instability for "real" banks, partially because regulators and bankers alike have been badly surprised by the degree to which the two (official and shadow banks) are entwined. Financial derivatives of all descriptions are involved, including SIVs, CDOs, and the most egregious CDSs. If you want to understand the shadow banking world you must learn this new alphabet soup of entities and investment vehicles. So follow along as we trace our way through the rubble.

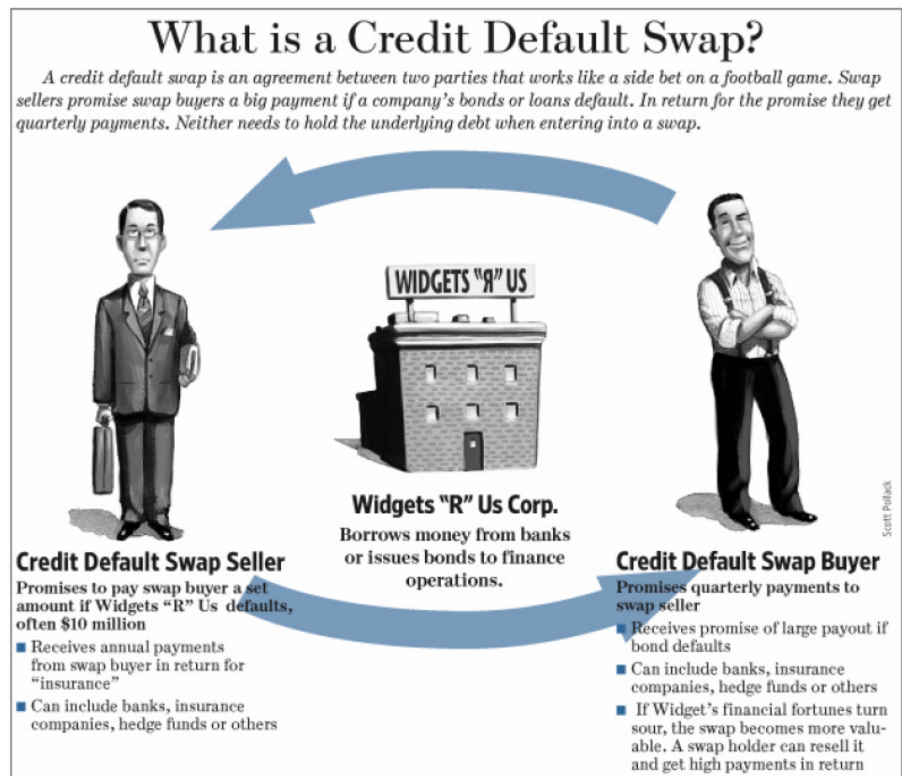
Until this summer, structured investment vehicles (SIVs), collateralized debt obligations (CDOs), and credit default swaps (CDS) attracted little attention outside specialist financial circles. Though often affiliated with major banks, they were not always fully recognized on a bank's balance sheets.

Structured investment vehicles, or SIVs, are bank-linked funds. In a way, they are a virtual bank. The SIVs issued short-term debt at relatively low interest rates and used the proceeds to buy longer-term debt carrying higher rates, including debt backed by mortgages. They have an open-ended structure which could stay open forever as long as they keep buying long term assets and selling short term debt. Why do this? Banks profited by setting up these structures because they pocketed the difference between the short term and long term rates, and they did not have to hold reserves for these loans that were placed off balance sheet. At their peak, SIVs held some $340 billion in assets, a figure that fell to a still whopping $265 billion by early December as they sold off some holdings.

When debt markets froze up in August the fear was that the SIVs would be forced to unload their assets in a panic. That would create big losses, the theory went, and set artificially low market prices for the assets -- forcing financial institutions to take huge write-downs. A government effort to stabilize the markets with the help of three major banks ultimately failed, but it did ward off a complete meltdown. The banks claim they are not responsible for the losses caused by these SIVs. Interestingly, despite their protestations, they are stepping up and taking the write-downs associated with these shadow entities they created.

CDOs are actually bonds, unlike SIVs which are entities which that hold assets. These collateralized debt obligations are structured products backed by an asset that has a cash flow, like a pool of mortgages. Other assets that collateralized these products are corporate bonds in various forms. Here's were it gets really complicated; there are synthetic CDOs that never owned the asset backed bonds or loans. They gained exposure to these asset-backed loans through the use of credit default swaps. Many SIVs purchased CDOs and synthetic CDOs.

So what is a credit default swap (CDS) and why are these contracts a problem? Brace yourselves, this is a mind bender. This is a vast, barely regulated market in which banks, hedge funds and others trade insurance against debt defaults. This isn't like life insurance or homeowners' insurance, which states regulate closely. It consists of financial contracts called credit default swaps (CDS) in which one party, for a price, assumes the risk that a bond or loan will go bad. This market is vast - about $45 trillion, a number comparable to all of the deposits in banks around the world.

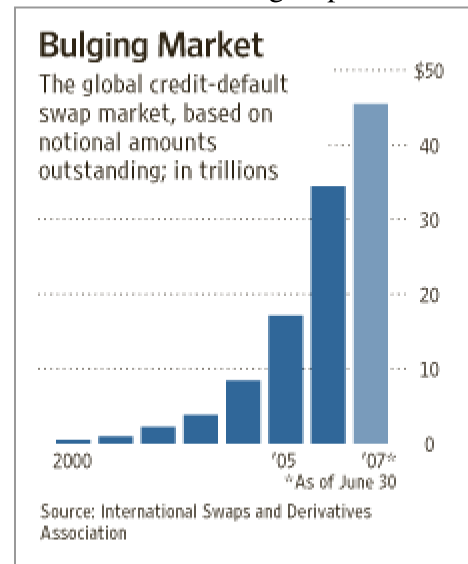


Originally, these contracts were intended to protect Wall Street firms from losses on mortgage securities and other debt they own. However, not everyone who buys one of these contracts has bonds to insure. Some players bought them just to speculate on market movements. These investors were basically betting on which direction the value of an insurance contract would rise or fall, which they did daily based on the market's perception of risk. In much the same way gamblers make side bets on football games, a financial institution, hedge fund or other player can make unlimited bets on whether corporate loans or mortgage-backed securities will either strengthen or go sour.

If they default, everyone is supposed to settle up with each other, the way gamblers settle up with their bookies after a game. Even if there isn't a default, if the market value of the debt changes, parties in a swap may be required to make large payments to each other (just the way an investor would have to put in more capital if the stock he bought on margin fell). Of course, Wall Street investors often use heavy borrowing to magnify their wagers. Recently, the ability of institutions to make good on their many trades with one another is beginning to falter. The turmoil on Wall Street could rock the foundations of the financial system around the globe if the major insurers of these contracts go under.

"What we are witnessing is essentially the breakdown of our modern-day banking system, a complex [or composite] of leveraged lending [that is] so hard to understand," Bill Gross, head of Pimco Asset Management Group recently wrote. "Colleagues call it the 'shadow banking system' because it has lain hidden for years, untouched by regulation yet free to magically and mystically create and then package subprime loans in [ways] that only Wall Street wizards could explain." By any standards, the activities of this shadow realm have become startling. Traditionally, the main source of credit in the financial world was the official banks, which typically forged businesses by making loans to companies or consumers. They retained this credit risk on their books, meaning that they were on the hook if loans turned sour.

Why has the financial model changed so radically in the last few decades? Why did the shadow banking system develop? Banks began to increasingly sell their credit risk to other investment groups, either via direct loan sales or by repackaging loans into bonds. This was made possible by new regulatory reforms, which have permitted the banks to reduce the amount of capital that they need to hold against the danger that borrowers default. They did this by passing their loans to new vehicles (SIVs) either by creating these themselves or by sponsoring outside fund managers to run them. This was a huge incentive because it allowed banks to make many more loans without having to raise more capital. These new entities have been instrumental in vastly increasing credit over the past three years. Paul Tucker, head of markets at the Bank of England, has described this as the age of "vehicular finance".



Bob Janjuah, credit analyst at Royal Bank of Scotland, estimates that these shadow banks could have accounted for half of all net new credit creation in the past two years. Because these vehicles typically borrow heavily to finance their activities, they have also been a key reason why leverage (or debt levels) across the financial world has risen so fast without regulators or ordinary investors being fully aware of this boom.

Hedge funds have had an oversized impact on the increase in the supply of credit. Satyajit Das, author and derivatives industry expert, cites an example where just $10 million of real (non-leveraged) hedge fund money supports one $850 million mortgage-backed deal. This means $1 of real money is being used to create $85 of mortgage lending. This is a level of credit creation that is far beyond the wildest dreams of any banker.

Since SIVs and CDOs have never been in the business of gathering deposits from customers, their significance to the economic and financial system has not been widely recognized by regulators and policymakers. The problem now is that the business model behind parts of this shadow banking world looks increasingly shaky. Essentially, the role of regulators in this world was replaced by the credit rating agencies, which awarded high, ultra-safe ratings to the debt issued by SIVs and other vehicles on the basis of historical analysis of the probabilities of defaults and losses across the shadow banking system. Now these vehicles' credit ratings are being downgraded. As the credit market absorbs this debt, it is contracting. The holders of these synthetic CDOs and SIVs are having the equivalent of a margin call, hence the large write downs

Jan Hatzius of Goldman Sachs estimates that mortgage related losses of $200-400 billion alone might lead to a pullback of $2 trillion of aggregate lending. Even if this occurs gradually, he writes, "The drag on economic activity could be substantial. Add to that my $250 billion loss estimate from CDS, as well as prospective losses in commercial real estate and credit cards in 2008 and you have a recipe for a contraction in credit leading to a recession." (I have to thank Bill Gross from PIMCO for this quote).

The problem is that it is difficult to quantify the losses and impossible to confidently forecast how restrictive credit will be and for how long. There is also fear that credit problems will spread to other areas, such as credit cards which have also had permissive underwriting standards. At this point, it seems pretty clear that banks will have more write-offs over the next few months or quarters and that structured investments (pools of debt that have been turned into securities), which are often highly leveraged, will suffer through more ratings downgrades as collateral values decline further. This suggests that the

current trend of less credit and higher costs probably has a way to go. This is true not just in the mortgage market (subprime and prime) but in the consumer and small-business loan market as well.

Problems like these do not get fixed overnight. They take months and sometimes years to unravel. It is obvious that whole parts of this economy (automotive industry) as well as whole regions of the country (Detriot with almost 8% unemployment) are in recession. The temporary fiscal plan proposed by Bush can't plug this breach. It will, at best, be a small levee holding back a briskly flowing river.

The housing market will still fall, lenders' underwriting criteria will tighten, consumers will spend less and the economy will slow to a crawl. Why? Because borrowing will no longer be cheap. The Fed can lower the interest rate to 1% but it won't take the 30 year mortgage rate past 5%. The mortgage lenders aren't offering teaser loans based on short term rates anymore. Only the 30 year mortgages are primarily available. So now you'll need to put down a 10% deposit to buy a house and can only borrow at the higher 30 year rates. Fewer consumers will now qualify for homes, cars, and credit card debt. So the consumer is out of the picture. Businesses won't be able to attain loans as liquidity continues to dry up. As I said before that just leaves the government and its stimulus package is a joke.

This is a mess that will be cleaned up by the next administration. Until then, the economy will bungle along. It will neither recover nor fall precipitously. The economy will be in a coma. The U.S. market should bumble along in the same trading range. As long as the stock market doesn't get an unexpected big shock (i.e. terrorist attack), we should weather the storm, a little care worn but a good deal wiser. The best scenario for 2008 is nothing happens. This is not very inspiring, but it's unfortunately realistic. Holding the course will be this year's mantra.

I fully expect that International stocks and bonds will outperform U.S. stock and bond markets due to the rapid growth of some overseas markets. The tail wind from international markets will bolster the performance of the large U.S. multinational stocks. Small cap stocks will continue to under perform. Whole sectors of the economy will do poorly, such as banks and the auto industry. Other sectors like energy and technology should continue to do well. Commodities and international bonds should also perform well. All in all it will be a tough, choppy year.

I look forward to hearing from you. Please feel free to make an appointment to review your portfolio.

Thank you for your confidence and trust.

Libby Mihalka

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