

- Fannie Mae and Freddie Mac are placed under government conservatorship
- Lehman Brothers declares bankruptcy
- Fearing the same outcome as Lehman, Merrill Lynch agrees to merge with Bank of America in an all stock deal worth \$50 billion
- AIG accepts \$85 billion loan from the government in exchange for the right to buy 79.9% of the company
- The 90-day Treasury Bill trades at a premium, providing purchasers with a negative yield
- Equity Markets experience sharp price increases and decreases totaling approximately a \$1 trillion change in value in a matter of days
- In an effort to keep the commercial paper market functioning, the Government pledges to guarantee most money market funds using the \$50 billion Exchange Stabilization Fund
- The Treasury Department and Congress announce plans to rescue banks from bad mortgage assets using a \$700 billion Resolution Trust Corporation like system
- The SEC temporarily bans short selling of 799 named financial stocks
- The two remaining independent investment banks, Goldman Sachs and Morgan Stanley, elect to become bank holding companies
- Representing the biggest bank failure in American history, Washington Mutual, is seized by federal regulators and simultaneously sold to J.P. Morgan Chase for \$1.9 billion

**Where do we go from here? An analysis of the facts and circumstances...**

- We believe the structure of the Wall Street investment bank will now change from the “originate and distribute” model and to old fashioned banking wherein the originating institution maintains part or all of the underlying risk of the issued loans. Moreover, the base of assets from which institutions lend will be much less levered, and less reliant on the capital markets. Instead, institutions will look to attract retail depositors backed by the FDIC to add stability and prohibit the modern era “run on the bank.” The changed business model and lower leverage will likely lead to less profitability from Wall Street in the long run. However, this will be offset to a degree in the short run due to the wide spreads (banks borrowing from the Fed at 2% and lending to customers at much higher rates) banks enjoy today. In the end, the new structure combined with a large dose of new and improved regulation should lead to a more stable financial system.

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- De-leveraging by banks will likely lead to less credit available, thereby hurting economic activity and certain investments (e.g., leveraged buy outs, select hedge fund strategies) in the short run. The scarcity of credit will also likely spark a wave of merger and acquisition activity as weaker competitors become forced out of a wide range of industries.
  - The market is now almost 1 year and 25% into the correction that began in mid-October, 2007. Prior corrections since 1950 have, on average, reached a trough in 12 months and declined 28.5%, roughly the amount and duration already incurred with notable exceptions occurring in 1973 (21 months and -48.2%) and 2000 (30 months and -49.15%). And, it is important to note that this correction is coming on the heels of a market that has essentially been flat for almost a decade, an event only seen in the Great Depression and 1973-74 Bear Market.
  - Although earnings are difficult to forecast in this environment, the P/E for the broad market appears to be relatively low at 13 times earnings in comparison to its historical average of 16. Other valuation metrics such as book value/share and dividend yields have also increased. Adding further credibility to the notion that value exists in the market today, Microsoft, Nike, Hewlett Packard and Wells Fargo recently announced shareholder buyback plans and respected investors such as Warren Buffet are making substantial investments in companies such as Constellation Energy and Goldman Sachs.
  - The root problem remains residential real estate, but with home prices off substantially (roughly 25%) from the July, 2006 highs and the 30 year mortgage rate below 6%, housing affordability (measured by mortgage debt services as a percentage of household income) could approach historical lows and begin to stabilize the housing market provided that credit is available and further declines in unemployment subside.
  - The other primary issues affecting the markets up until the last few weeks were: the rising price of oil and other commodities, rising inflation and upward pressure on interest rates, and the falling dollar. While spiking a bit in some cases over the past few days, all of these have seen rather dramatic reversals. Oil is down from a high of \$147 to roughly \$70. The Consumer Price Index recently turned negative, interest rates have fallen, and the dollar has rallied. The reduction in commodity prices will relieve the Federal Reserve from having to raise rates to fight inflation; thus monetary policy should remain easy with the Fed injecting money into the financial system through its new and old credit facilities and keeping the Fed Funds rate at 2% for the foreseeable future.

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- Two other important factors should also change in the next few months. The presidential election, barring a tie, should be decided in the late hours of November 4th. The market hates uncertainty and, regardless of the outcome, one cloud of uncertainty will be lifted. Secondly, corporate earnings have been negative for three quarters. In light of recent events, estimating the value of these toxic assets using theoretical models will give way to reality. Thus, all remaining losses stemming from mortgage-backed securities CDOs and SIVs should be taken. While the slowing economy has certainly caused earnings to fall, the numbers turning negative have primarily been a function of the write downs in the financial sector. Thus, we believe the market should begin producing positive earnings instead of losses next year, barring additional economic developments.
  - A weak U.S. consumer purchasing fewer foreign goods will test the budding growth of emerging economies but the powerful trend should remain intact. With capitalism taking root all around the world and with our consumer society spreading to the roughly 4.5 billion people from emerging markets, a new global middle class has and will continue to emerge, increasing demand for infrastructure and consumer goods, and creating healthy profits for the companies strategically positioned to capitalize.
  - Financial crisis are not a new phenomenon. Sure, they each have a unique aspect and feel different at the time begging some to exclaim that this “time is different”, but the similarities are always closer than one might expect. The following is a brief entry by Peter Lynch made a few years after his retirement in 1990 that draws interesting parallels to today:

“Everybody talks about how frightening the 1987 crash was, but to me 1990 was a much scarier time. In 1990 banks were failing. The savings and loans were in trouble. People’s homes were falling in price. You had Chase Manhattan Bank, Citibank, Manufacturer’s Hanover, big banks, and people were saying they were going up in flames. Bank of Boston was selling for three bucks a share...On top of that, you layer on the fact that we were in a recession. And just to make things a little worse, we now had five hundred thousands troops in Saudi Arabia about to fight Iraq...People were sitting on their sofas debating body bags...Taxes were going up...If you line up all those things, it was the worst set of circumstances in my thirty-year career.

I stopped running Magellan in May 1990, and I think the market was at 2,700. By July, it was up to 3,000. That’s when Saddam Hussein walked into Kuwait with his army. The market went from 3,000 to 2,300. We had a 20, 25 percent correction. But guess what...the banks didn’t go under. The market didn’t anticipate a quick recovery, so 1991 was one of the best years in a long time to be in stocks because most people were looking for a rebound maybe in 1992 to ’93.”

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