

“At the Brink: The Real Story”

Hammond Associates Conference Call
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I. Overview

Thank you for calling in and joining us today for our second teleconference on this issue. The reason for the call is the markets' activities and the seeming lack of information, or abundance of misinformation, that we think is being tossed around by various sources pushing one or another version of what is happening and what caused it all. The blame game is in high gear and right now pointing to two main villains – Wall Street greed and lack of regulation. In our opinion, both of those are rightly named, but are far from alone in deserving blame. To attribute the whole fiasco to them is a huge oversimplification, and a distorted and incorrect view of what has happened.

I've given this piece the title “At the Brink: The Real Story.” I'll identify the brink we're standing on; secondly, how we got here, and third, what's next – that is, the implications for the market and what we recommend be done about it. So let's start with the first part, the gloom and doom, and then we'll get to the more Disney-esque part. But first, At The Brink.

II. The Brink

One of my colleagues, Dick Anderson said to me yesterday, “Dennis, that's kind of a scary title. Why would you say ‘At The Brink?’” This was back on Monday October 6, and the market was down, at the moment I was on the phone with him, about 8%. I said, “Gee, Dick, if we're not at the brink, what would it feel like? If we're not at the brink now, we're down in the abyss looking back up.” I think most of us felt that. As you probably know by now, when the Dow opened this morning in New York, it immediately dropped 1,200 points on the opening bell, about a 12% drop, down to 7,800. It's come back up now, thank goodness. We've had six or seven markets that simply stopped trading last night – fortunately, not the U.K. or any of the other big ones – and the S&P so far, on the 10th calendar day of the month, is down 22%. When added to the 9% drop last month, I think we're probably down in the high 30's at this point. What makes this bear market seem so severe is how quickly things have declined. The 2000 to 2002 bear market was worse. It was down 49%, but the fall from peak to trough took 31 months. The '73-'74 bear market saw declines of 48%, but even that took 21 months. We've dropped some 25% over the last nine trading days. At any rate, the brink that we're talking about – and what we're concerned about – is a global credit freeze. Banks are fearful of missing their capital requirements and so they are simply not lending. Borrowers, including corporations, municipalities, states, consumers,

even countries – and banks themselves – cannot get credit. Even regional and major national banks have stopped making loans or extending credit. LIBOR, as we've seen, has frozen up several times in the last few days. Today, it's almost double what it was a few weeks ago.

What is the impact of a global credit freeze? Simply put, existing loans don't get refinanced, and no new loans are extended. Commercial paper – which is sold by the largest corporations and used to finance their day-to-day operations – goes unsold, so corporations *can't* refinance daily operations. Consumers can't buy. On a more technical point, counterparty risk goes up. We'll talk about credit default swaps in a few moments. Credit default swaps are essentially insurance contracts written on bonds and other credit instruments. Today, there's about \$220 billion worth of that insurance coming due on the Lehman bankruptcy. Firms from AIG to the PIMCO Total Return Bond Fund must pony up about a quarter of a trillion dollars to pay off those contractual obligations to make good on the Lehman debt. Meanwhile corporations, unable to roll over their short-term debt, can't buy inventory; they can't make or market products. You've probably read reports that General Motors, Ford, [and] Chrysler could all face bankruptcy in coming weeks. If they can't find financing to stay in business until their customers find financing to purchase their products, they face extraordinary difficulties. When that happens, corporations, municipalities, states, and others lay off their workforces, which raises unemployment. You may have seen in today's paper that California was one of the first states to be hit by the recession in the United States. Their current unemployment rate is nearly 8%. Higher unemployment means lower consumer spending, which means reduced corporate profits, and both potentially translate into still more defaults and still tighter credit. It's a very nasty negative feedback loop, with a clear potential to devolve into the mother of all vicious cycles. One bank failure causes loans and packages of mortgages to fall further in valuation, which puts one or more other institutions in danger of missing their capital requirements, and so forth. The latest concern, starting this week, is the extension of this problem to major life insurance companies, like MetLife and others whose life insurance operations, which are highly regulated and are underwritten by their investment portfolio are running into capital problems because of the losses they've experienced on their investment portfolios.

So back to the question: Are we at the brink? Well, I would suggest we are. Gone are three of the five major investment banks – Bear Stearns (sold to J.P. Morgan), Merrill Lynch (sold to Bank of America) and Lehman Brothers (in bankruptcy). Today, Morgan Stanley, one of the remaining giants, is up against the ropes, driven there by short sellers. It has to get through the weekend and pass the Columbus Day bank holiday if it's going to survive to be bought by Mitsubishi, and the jury is out on whether it can. That would leave only Goldman Sachs, which, as you know, in the last several weeks has morphed itself, along with Morgan Stanley, into a commercial bank holding company. Also gone are some of the largest mortgage originators in the nation: Countrywide, American Home Mortgage, Wachovia, WaMu. Gone are the federal mortgage agencies: Freddie Mac and Fannie Mae. Going (but not yet gone) are corporations who are otherwise healthy, but cannot refinance their operations through commercial paper. Also going might be states like California. We've heard Massachusetts has recovered by finding a different way to finance its operations this

week. Kentucky was able to raise a significant offering, which enabled it to continue operations at a relatively cheap rate yesterday. Also going, as we know, are the global equity markets, as they seem to be freefalling in recent days. Going, or MIA, are homebuyers. It was reported earlier this week that the foreclosure rate among the entire pool of domestic homeowners may reach 13%, an unprecedented level. This is not 13% of subprime and the Alt A loans going into default, but of mortgage holders in the aggregate. Going also extends to commercial banks, unless they are able to raise fresh capital. Insurance companies, money market funds, and even bond funds are having trouble meeting their obligations because some of their investments have declined so far in value. BBB-rated mortgage paper is now 50% below face value. If you have an asset on your books that has declined 50%, and you bought that asset with capital that was levered 30 or 40 to 1, you can imagine that would wipe out all your capital. Clearly, when Bear and Lehman and Merrill were wiped out, they were levered as much as 40 to 1. Morgan and Goldman were levered in the 20s. It is thought, that at this particular point in time, globally, the banking system has had losses on mortgage-backs and other securities approaching a trillion dollars. We have found some fresh capital for them: \$700 billion in the United States, and abroad even more. The point is that whatever the eventual losses, that sum, less fresh capital, will go into the capital requirement structure of these banks. That number needs to be something like a trillion dollars or better; that's why the federal government stepped *[in]* with a \$700 billion bailout. With a 10 to 1 net capital requirement ratio, that gave banks as much as \$7 trillion in new capital, of which they were and still are in desperate need.

The *good news* in all of this is, in our opinion, *[we]* have at the helm some of the best and brightest minds America could produce for just these kinds of situations. Ben Bernanke *[at]* the Fed, and Hank Paulson with the Treasury, are two of the best folks we could possibly employ to help deal with this. Bernanke has seen the problems and written extensively on the Great Depression and the failure of the federal government back in the Great Depression to finance the credit crisis that occurred at that time, and the resulting freefall in credit drove the stock market down 89%.

III. How Did This Happen? Who's to Blame?

What happened and how did we get here? Interestingly, several years ago Warren Buffett was quoted as saying that "credit derivatives are financial weapons of mass destruction." It seemed humorous at the time, but has lost its humor recently. We now see that we used these instruments to create a credit bubble collateralized by home mortgages. The cast of players in the blame here extends to all of us, and is wider than anyone has suggested. I've got ten (names) on my board, and we'll go through those ten, not in any particular order, but let me just mention them.

1. Government Policies

Government policies have for a long time now – since at least the late '70s – heavily tilted in favor of home ownership. The concept, altruistic at heart, was that we should have more of our citizenry able to purchase their own home. That policy was enabled by the Community Reinvestment Act in 1977. It was seen in the administrations of both political parties, the Clinton administration in '99, and the Bush administration as recently as 2004, and certainly from

the recent congressional leadership, including principally Rep. Barney Frank. The result has been a big push in social policy to encourage home ownership, which certainly is a good thing of itself.

2. Freddie and Fannie

Encouragement from the federal government caused our federal mortgage agencies, Fannie Mae and Freddie Mac, to relax their lending standards on the mortgages they buy.

3. Investment Banks

In turn, the Wall Street investment banks began securitizing and then selling pooled mortgages. Now to do this, they had to get more capital. So the five main Wall Street investment banks (three of which are now gone), Bear Stearns, Lehman, Merrill Lynch, Morgan Stanley, and Goldman, went to the SEC in '04 and requested an exemption, applying only to themselves, from the 12 to 1 capital requirement that had been in existence for many years. The SEC permitted that, allowing the five big banks essentially to act at their own discretion in determining their need for capital. In Merrill's case, leverage was at a ratio of 40-to-1 when it finally was sold to Bank of America.

This amounted to a huge infusion of capital, with which the investment banks began creating enormous pools of mortgages. These pools of mortgages were sliced and diced according to the perceived risk of the underlying loans, and the time until they would be paid off. Rating agencies were paid large fees to grade the risk, and insurance companies were paid large fees to underwrite it. In the marketplace, these pools were sold as CDO's, Collateralized Debt Obligations, and institutions from banks, to money market funds, to bond funds, to endowments and pension funds, to sovereign funds, and even to central banks, bought them up. The investment banks themselves retained the lowest tranches of these CDO pools, the high-risk/high-yield instruments, now known as "toxic waste." Their decision to retain these lowest-tranche bonds on their books, leveraged to dizzying heights, eventually brought on the banks' undoing. When the housing bubble broke, those mortgages fell so far in value that they quickly outstripped the capital the banks held or could raise. We first started discussing the housing bubble in our second quarter 2003 Quarterly Research Report. We started talking about the credit spreads in the fourth quarter of that same year, 2003. We started talking about the implication the housing bubble might have on the broader economy in the second quarter of '05. But I guarantee you, we never had any clue it would get this bad.

4. Mortgage Originators

With investment banks securitizing and wholesaling pools of mortgages, mortgage originators soon saw that they had a ready market for any and all the mortgages they could gin up. So mortgage lenders like Countrywide, American Home Mortgage, Golden West, Wachovia, [and] WaMu began a land rush for new mortgage loans. Anyone could get a mortgage loan. The so-called "Ninja" loans occurred at the time, which were no income/no job/a-okay. Many of these loans were made with no money down, and no verification. The point was: The mortgage originators earned a fee and they had a ready buyer for every loan they could turn out. The ready availability of these "subprime" loans obviously

encouraged a lot of people to buy houses who shouldn't have bought houses. It also encouraged people who could buy a house, to buy "more house" than they should have.

5. Accommodative Federal Reserve

In addition to the mortgage originators encouraging home buying, the Fed's policy was accommodative. That meant cheap money was being pumped into the system. The Fed Funds rate was cut to 1% in June 2003, and stayed there for a year and five days.

6. Homebuyers

With the investment banks buying all the mortgages they could buy, and mortgage originators lending all they could lend, and Fed policy encouraging people to buy more house than they should buy, homebuyers took the hint, and rushed out to gobble up everything in sight. When they filled out their applications, sometimes they were encouraged to lie and sometimes they lied all by themselves. But at the end of the day, they filled out applications, bought houses, and bought lots more than they should have, driving our national savings rate, I might add, down to zero, and at one point in recent years, below zero. Those of us who didn't buy a house did take the opportunity to run down to the bank and borrow against the house we had, because equity was skyrocketing. We took that money, went right down to the car dealer, or to the mall, and spent it. That spending propelled corporate profits to record levels, which made our stock market look like it would rise forever.

7. Credit Rating Agencies

As we now know well, the stock market did not rise forever. Instead, it did what it often does when such delusions take hold: It launched itself into a violent downward spiral. While we're meting out the blame for this calamity, I would like to revisit a group I mentioned earlier: the credit rating agencies. Having quickly grown enamored of the rich fees charged investment banks for rating complex CDO's, the agencies discovered their profits grew fatter as their ratings became more generous. It was a simple matter for investment banks, if displeased with a rating, to go elsewhere, taking their lucrative business with them. This was a powerful lever, and before long agencies determined that 70 to 80% of the tranches in even the most odiferous CDO's merited a Triple-A grade. You may recall that in July of this year, the SEC finished a ten-month probe into the rating agencies saying that they had significant deficiencies in policies and procedures. No one went to jail however.

8. Insurance Companies

The insurance companies, AIG and others, underwrote these CDO pools. This form of insurance was called "Credit Default Swaps," which, as I mentioned earlier, are simply contracts. The problem with credit default swaps is that there are \$55 trillion worth of them outstanding at this particular time, and not a ghost of chance that the people on the hook for potential losses of such magnitude ever could make them good. You knew that AIG was one of these issuers and the federal government was loaning them \$80-some-odd billion. You may have seen in today's paper that they've already had to increase that number to \$123 billion.

9. SEC

A recurrent theme in all of this is the negligence of the SEC. The commission simply failed to conduct the oversight of the Wall Street investment banks that it was charged to perform. As a result of the virtual exemption on capital requirements given these investment banks, the commissioners were caught unawares and absolutely flat-footed. I'm told that the division of the SEC required to watch over this still does not have a managing director today.

10. Investors

Finally, the last fellow in the chain of blame here would be us, the investors. We all snapped up these CDOs. They were great buys. They were thought of as great bargains. After all, they were AAA rated, insured against default by the largest insurance companies in the world, and collateralized by the homes of all the good folks in the United States. In fact, you had investors globally buying these securities. China ended up with fully one-fifth of its currency reserves in Freddie Mac and Fannie Mae paper, which may have something to do with why the federal government took those agencies over as quickly as it did.

IV. What's Next: Implications for Investors

We need to talk about what's next. Obviously, we're in a global recession. We think the recession began in the United States in January, despite modest gains measured at the time in the GDP. We, of course, cannot know if this recession will be among the longer-lived of its species, such as the '73-'74 recession that endured 18 months, or if it will be relatively short, in the 9-to-12-month range. Likewise, we can't be sure of its severity, which probably depends upon the efficacy of the many drastic countermeasures taken by governments and central banks around the world. The negative aspects are that this recession is caused by the bursting of a credit bubble that took years and years, a decade almost, to reach the failure point. So a lot of global deleveraging has to happen as banks and other institutions raise new capital, sell assets, or both. On the other hand, we could argue that the federal government, in concert with central banks in Europe and Asia, is intervening so vigorously in this crash that we'll recover more quickly. There's no doubt we have seen more work done in cleaning up this mess in the last six days, or the last six weeks, than ordinarily could be expected in six years. It is therefore difficult even to guess whether it will be long or short. We simply don't know. We do know that the Fed didn't seem to accomplish much yesterday with its interest rate cut. The Fed and the Group of Seven intend to meet today and over the weekend to try to come up with a coordinated plan to invest money into banks globally and perhaps change investors' sentiment. And sentiment has more than usual importance in this trouble, at least from the market standpoint, and from the bank standpoint. Banks must be encouraged to begin lending again by assurances from governments, and eventually investors, that they do have a backstop. The most recent recommendation is that the U.S. Government step in through the FDIC or by other means and essentially underwrite all banks for all loans.

Well, what does it mean? It means that in the short-term, we'll probably see a lot of deleveraging, which is deflationary. As banks sell assets – those assets being loans – and curtail making new loans, and that will force prices to fall. In the longer-term, this unprecedented global government intervention is inflationary. When the government is printing some \$2 trillion of new paper, I assume the presses are flying every night. That expansion of the money supply is inflationary, so long-term this should be an inflationary event.

What, then, do we think we should do with portfolios?

1. Cash

Short-term, cash is king. If the government is unable to convince banks to begin lending again, or if the banks simply are unable, or the money market funds and insurance companies and others are unable to supply capital, we could see further freezing of the credit markets. American Express, last week, was having a hard time with its commercial paper until the government stepped in on Tuesday and said, for the first time since the Great Depression, the Fed would start buying commercial paper directly from public companies. Question: If American Express can't get its paper sold, what does that mean for credit cards? In such circumstances, we suggest that clients think about keeping cash. However, I would not raise cash. As you'll hear me say in a moment, I would not sell equities. But, if you have a credit facility, you might want to use it.

2. Hedge Funds

That brings me to what we see for the intermediate to long-term. We think, at the end of the day, this is going to be the single, best, most massive opportunity to make money any of us have ever seen. We're looking at opportunities to make money that none of us have seen in our lifetimes. For example, we started saying about ten years ago that the market was priced to perfection. There weren't any soft pitches. The equity risk premium on stocks over bonds was zip. Well, that's not true today. For example, our hedge funds are buying bank debt that is currently priced to provide 20% unlevered returns. Hedge funds are also buying residential mortgage-backed securities that offer great reward with little risk. Some of these structures are available for 10-20 cents on the dollar. In order for these things to go broke, 90% of the home mortgages in the structure would have to be foreclosed, with less than a 50% recovery value. I just don't think that's got a high likelihood.

3. Credit Spreads

Another opportunity right now is investment-grade corporates. I'm not talking about General Motors. The automakers are in the junk category at the moment, but there are investment grade corporates now that have spreads to Treasuries we've never seen before. We're able to buy AA corporate paper for 7% or 8%. The risk here is that these corporations, good companies like J & J and Gannett and others, won't be able to refinance their day-to-day operations. They can't sell their commercial paper. But if the government, as they said on Tuesday, is willing to step in and backstop that paper, then we're okay.

4. Distressed Debt

We think this is going to be one of the best opportunities we've ever seen for private equity to buy distressed debt. I have no idea what the size of the distressed debt market is going to be over the next year or two, but we know that our distressed debt managers are buying at prices they believe are a once-in-a-lifetime opportunity.

5. LBO's

We also expect to see our private equity managers make a lot of money for clients through leveraged buyouts. Historically, LBO's bought during a recession have the highest return among all vintages.

6. Equities

Longer-term, we think equities are starting to be a terrific buy. We've been a bear on equities over the last several months and years, but we've turned bullish. We've changed our recommended research portfolio allocation for long-only public equities from 35% to 40% as of two days ago, and we expect to continue to increase our allocation to public long-only equities if this market continues to fall. The lower the market value of the equities get, the higher their expected return in the future. So we're watching P/Es. At the beginning of this year, our research portfolio was allocated only 15% to public long-only U.S. stocks, because we thought the expected return was low, with an aggregate P/E ratio, as we look at it on a normalized basis, in the 20's. It has now fallen to 16, as of a few days ago, and today it may be in the low teens. We want to be buyers at 15. We want to be buyers of P/Es at 12 or 13. We want to be buyers of P/Es at 9 or 10. At its nadir, just before the last real bull market was launched, the P/E for the S&P was eight. We want to buy all the way through that. The problem is we don't have much in the way of dry powder right now, so we're going to be looking hard at how to do this. But, we think equities are good bargains today, and are going to get better and better. That's the equivalent of saying we think they will fall farther. I expect them to fall farther. I expect them to fall down to, and maybe through, the old levels because usually markets don't stop when they should. They overreact, over-stretching, storing energy, like a rubber band.

7. Hard Assets

We also think inflation will create opportunities in hard assets, and therefore we include commodities: timber; real assets; even (yes) oil and gas will be good investments because of the inflationary potential in the environment we're creating for ourselves. Oil fell today below \$80 a barrel. That's because folks think demand is going to be low, and that's probably true. During a deflationary period, or a recession, demand for oil does drop. But that's not a long-term, secular phenomenon. Long-term we're going to continue to grow our global output of goods and services, and energy is going to be a terrific place to be, especially if you can buy at today's fire sale prices.

So I'll finish by simply saying, "Yes, we are at the brink." We have been at the brink of a global credit freeze. We got here over the years through favoring home ownership, trying to do the right thing for homebuyers in the United States.

The securitizing and selling of vast sums of pooled mortgages, with homebuyers rushing to buy more than they could pay for — all prompted and abetted by highly accommodative government policies — fed a very large credit bubble. But now the credit bubble has burst, and we're dealing with the valuation of the collateral for most of that credit. This will pass, and we believe that it is creating massive opportunities for investments for the next 10 to 20 years. Institutions with long-term horizons will look back and say this was one of the best buying opportunities in their history.

Q & A:**Q: Where is all the cash right now, and how long are they going to sit it out?**

A: [Dennis Hammond, CEO]

We believe the cash per se, the unspent capital, is being hoarded by the banks. They don't even want to lend it to each other. LIBOR stopped. There was a posted rate a few weeks ago, but you really couldn't get money from one bank to the next unless you had collateral. They were going through the Fed window. Once the banks stop lending and the credit stops flowing through the whole system, it's like any other circulatory system; parts fail and that's the problem. The banks are doing that because they don't know who to loan to, or to loan it longer than overnight. That's because, if they loan to ABC Company or XYZ Bank or 123 Insurance Company, they don't know that they'll be in business in six weeks. So the government has to come in and say, "We will assure you that your loans will not go into default, because we'll be there. Essentially, we're going to give you a put *[option]*. We will be the borrower of last resort – or the guarantor of last resort – on your loans." Well, that's where the cash is.

Q: You talked about hard assets and the opportunities in hard assets in an inflationary environment. Could you *[talk]* about investments in apartments and commercial real estate?

A: [Harry Leggat, Hammond Associates Private Equity Group]

Yes. I would say that the strategies we have focused on primarily over the last couple years have been more value-add versus core strategies, meaning they're strategies that are focused more on creating value through improvements to the assets versus buying assets that are more income oriented and yield oriented. As a result, I think we're not seeing as much of a hit in the short-term, but everything is being depressed. Cap rates are widening out, which means that asset values are coming down relative to the income that those assets yield. We do expect that these portfolios will suffer some poor performance; but in the long run, we do believe that they will be attractive. You mentioned apartments. That is a sector that we have been investing in over the last year, mainly because we think there will be more renters by necessity rather than renters by choice.

Q: Maybe you could elaborate a little bit on where you've invested in the apartment sectors? Is that in different REITs?

A: [Harry Leggat, Hammond Associates Private Equity Group]

We have not been using REITs on the private side. We have mainly been using private managers that are focused on workforce housing as opposed to garden-styled apartments. Workforce housing tends to be in more of the urban areas and they cater to more of a blue collar type of renter. Their strategies have been nationally focused. We're not focusing on... We're not overweighting any particular geography.

Q: I am treasurer for a small foundation and we're required to make a 5% distribution every year; and with this current market, obviously, we have lost in our corpus, and you mentioned that the important thing is to keep cash but not to raise it. How do you... What... So I have two questions is- How do we manage... What's the best way for us to manage this because we do need cash to pay out, but I'm not sure that we have the full amounts that we would need I think to sell some stock? Then, do you recommend...Our current asset allocation is roughly 70/30, so it sounds like you're saying to keep - - to hold because this is such a great opportunity that it will come back in the long run. I'm just concerned because this is a foundation.

A: [Dennis Hammond, CEO]

Well, you have put your finger on the tough issues. Let's start back with the first point about the 5%. Certainly you're required to make a 5% distribution. I wonder whether you will not have... This is kind of bad news/good news. Bad news is the stock market has caused your portfolio to decline. The good news is 5% is not as many dollars as it was, depending on when you use - - what day you use as your valuation date. Some foundations will use a valuation date at the beginning of the year, some at the end of the year, and some are actually using endowment methodologies, calculating a rolling valuation period of the last 12 quarters. At any rate, you are going to have to come up with a number. Unfortunately, the 70% in stocks has been - - it was a good idea; but over the last several years, that idea has not worked well. Our recommendation is that you look at your treasury portfolio, that 30% of the portfolio, and look in there for sources of cash. We would probably start with TIPS, if you have any Treasury Inflation Protected Securities. Even though we think inflation's going to be a big problem in the next several years, we think in the near-term, you're probably better off with the cash for operating funds and for your spending policy. Anthony Brown, our Chief Investment Officer is here with me, I may ask him if he would like to chime in on this.

[Anthony Brown, CIO]

If your policy was 70/30, just on a normal rebalancing, you would be taking that money from bonds rather than stocks. So just sticking to your policy, you won't be liquidating equities and so, yes, I would stick to your policy and then, as Dennis mentioned earlier, you might also think about raising your policy allocation for equities at some point, although, you're quite a bit higher than some of our clients are.

Q: On the 40% long equity, I was curious as to your take on U.S. versus Asia versus Europe versus emerging; and then if you choose to answer a second question, that would be some derivation of: What are the CALPERS of the world doing and some of the big institutionals? Are they following their policy, or is that something that typically happens later? Would they be rebalancing now, I guess is my effective question?

A: [Anthony Brown, CIO]

For the first answer: We have moved to more of a market weighting in our allocation between U.S. and international, so that weighting has been going up in internationals relative to the U.S., and I think it's swung from the old 60% U.S./40% ex-U.S. to just the opposite in recent months. We are also thinking at this point about increasing our emerging markets above their market weighting because they've tumbled so far. Emerging markets this year are down about half, and we thought they were overpriced at the beginning of the year and now we think they're cheap. So we are beginning to move that 5% that we're moving into public long-only equities, about 3% of it we may move into the U.S. market and the other 2% at this point we'll probably overweight emerging markets. When we get to the next tranche of 5% going - - moving into the equity markets, we'll probably put a good part of that in international large stocks because they're - they were cheap at the beginning of the year and they're getting cheaper.

In terms of your question about what the big institutions are doing with their rebalancing policies, I'm not sure what they're doing. I can tell you that we have told our clients not to wait until the end of the year or the end of the quarter or any of those time-based observations, but rather to rebalance any time the portfolio gets out of whack by a percentage of the allocations to each asset class. Usually that's about 20%. So if a... We allow 20% band around a target. So if you've got a 10% target and it gets to 13 or it gets to 7, we typically rebalance, and usually that doesn't require us, as you know, Todd, you run a company like ours, that doesn't require you to rebalance more than once or twice a year. This year we would be rebalancing every other day, so that hasn't... We just haven't had time to get in front of clients with rebalancing issues, but we certainly will. We believe we must rebalance. The failure to rebalance, even in times like this, is a de facto change in the asset mix, and we don't believe we should do that. Good question.

Q: I was curious about your thoughts on investment in raw land.

A: [Dennis Hammond, CEO]

The only thing I can tell you is obviously it's all about location, right? You've got usually no income unless its crops and you've got carrying costs. But, Harry, could you give us any insight?

[Harry Leggat] Sure. I would say that generally our policy has been against investing in raw land primarily because of the reason Dennis mentioned, which is there's a negative cost of carry. You're paying taxes. I know there's such expenses in order to hold raw land and it cost money to improve that raw land if you wanted to, for example, get it zoned and get other passages for improvement. Now if you're buying it as a part of a development project and you've got a plan, then that's another story. But generally buying raw land also requires a rather long-term hold which can be problematic as well.

Q: Yeah, two questions for you. One, do you like municipal bonds at this point and do you see any risks associated with it? The second question is whether given the fact that you mentioned inflationary pressures going forward, do you like gold?

A: [Dennis Hammond] Anthony, you want to talk a little bit about munis and gold?

[Anthony Brown, CIO] Sure. Well on the muni side, I mean clearly there are risks right now, but it seems like you're being very, very well compensated for that risk. I mean it's so hard to keep up with these numbers right now, but I think munis are now yielding around 6%. Of course, the tax advantage a yield versus a treasury yield is now about 3.80 or 4 on the ten-year. So I think munis are very attractive right now, but you do have some risk there. Municipalities are going to have a lot of challenges in the coming years because of the property tax revenue declines. If we are in a serious recession, sales tax revenue declines. But overall, we are optimistic over muni bonds.

On the second question of gold, we've always struggled with whether to have a gold allocation. Again, here's another asset that produces no income and it's an asset that you actually have a cost of carry, not quite as much as raw land, but you do have to pay a certain amount every year just to store your gold. So we shied away from gold and focusing more on say energy investments and other hard asset investments typically through companies, whether it be a private company or through public companies, and so we still lean toward that direction because I mean we believe even if gold stays flat or declines from here, you could still have the miners and with oil, the producers, producing positive returns.

Q: Sort of building from the last question, do you have a viewpoint on the potential impact of the downturn on public pension funds, and this is both long-term tax and potentially state budget impact given many of these are already massively under funded.

A: [Dennis Hammond, CEO] Well I'll try that, and I'm going to get Anthony to add in. We don't have the fellow on the phone, I don't think, who runs our Public Pension Group. But just in broad picture, to start with: Most of the public pension funds in the United States were under funded relative to reasonable funding requirements at the beginning of the year anyway, and they've been using these relatively ridiculous, just like the private public funds, relatively ridiculous actuarial assumptions of Goldilocks kind of returns on the stock market in order to make their actuarial funding look better. In addition, many of them did not adopt the kind of asset allocations which were lighter in public equities and more reliant on hedge funds and private real assets and private equity assets that the endowments and the foundations did rely on. So my guess is that going into this they're probably not as well positioned and more exposed to the public long-only equity markets. I don't know that for a fact, but that's kind of my guess. We've

heard some issues from Anthony about the ability of states to continue to fund the pension obligations. In the short-term, when you have states like California and Massachusetts already asking for federal bailouts, there is some concern, but their income's going to go down, their government funding may not be there. It seems problematic to me. Anthony, do you have anything you could add on this?

[Anthony Brown, CIO] Well, not too much, but I think that is going to be a big issue in the next decade or two. The economics just don't work right now for public pension plans because they are - - the typical one is paying very generous benefits and there's no way they're going to be able to fund those benefits without massive tax increases or cutting benefits. So one of those two has to happen over the next decade or two, so that's going to... Expect to see that as a huge political issue.

Concluding Remarks: Dennis Hammond, CEO

See, everybody already knows the answers to this ... BUY. Thank you so much, everyone, for taking your time and for calling in and listening. We really appreciate the opportunity to serve each and every one of you, and we look forward to seeing you in our upcoming quarterly investment reviews over the next several weeks.