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1st Quarter 2008

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

The Quarter That Most Would Like To Forget

The first quarter of 2008 was one of the worst for the stock market since the bear market of 2002. The near collapse of Bear Stearns was the most visible debacle of the quarter, but underneath the sea of volatility was a chasm of illiquidity that the markets have not seen in a generation.

A letter of this sort cannot possibly cover all of the incredible events of the first quarter and explain why, or why not, they should have happened or what may have been done to avoid the pain. Therefore, we will not try. Besides, what is done is done, and what has not yet happened is what really matters. That said, many people will look at their statements for the quarter and want to understand why the market dropped so dramatically. Hundreds of pundits will give you a myriad of reasons, all of which have validity. We will attempt to break it down in very simple terms based on what we believe are the core two reasons for the decline: liquidity and fear.

The Evaporation of Liquidity

A number of clients have asked the question why illiquidity in exotic financial instruments such as sub-prime mortgages, credit derivatives and leveraged loans would cause the stocks of companies that have nothing to do with banking/brokerage to go down. It is a reasonable question and one that does not appear to have a simple answer. The reason is actually a lot more straightforward than people realize…blood. Huh, did they say blood? Yes, we said blood.

What makes all the parts of the human body work? There are a lot of very important parts to the human body: brain, heart, lungs, etc. But what do they all have in common? They all need blood in order to function. Without blood, they all stop working and the body dies. If blood is not delivered to an organ, it sets off a chain reaction that ultimately shuts down the entire system if the flow of blood is not restored.

What in the world does that have to do with the financial markets? Everything! Liquidity (the availability of capital to spend, borrow and invest) is the blood that makes the parts of the system work. Without liquidity to a particular area, it can start a chain reaction that ultimately shuts down the entire system. Sound familiar?

Suffice it to say, if the flow of liquidity is disrupted and unavailable to investment banks and/or commercial banks, the lenders who make loans to students, homeowners, car buyers, corporate buyers of other businesses, private equity buyers of businesses, real estate developers, etc., etc., simply cannot make loans. Thereby, the demand for assets drop which causes a drop in price. That drop in price then triggers more reductions of capital, which creates less ability to lend, which…well, you should get the picture.

The reasons for the disruption of liquidity are well known. Overvalued housing prices decreasing knocked down the house of cards created by the incredible greed of an entire industry who truly believed that house prices could only go up. That chain reaction led to a massive shortage of capital created at the very organizations that tend to provide the blood flow of liquidity to the economy—the commercial and investment banks. Make no mistake, the housing bubble is not the sole culprit here, but it was the catalyst that created the domino effect that is playing out today.

Some clients have asked why a few billion dollars of write downs could cause such dramatic reduction in liquidity. That is a good question, although it does make us wonder how desensitized we have become to large dollar amounts. A few billion here and there and you start talking about REAL money!! A billion dollars in the right hands can literally change a million lives, but we digress. The reason why these write offs at Bear Stearns, Merrill Lynch, Wachovia, UBS, etc., matter so much is because of the enormous leverage that these institutions use in their business models. Many people don't realize that banks lend out much more in capital than they have on their balance sheets. This creates an enormous contraction when banks have less capital to leverage.

To give a simple example, let's assume that Bank A has $10 Billion ($10B) in capital today, which is the net asset value of their organization. They then allocate out $100B, roughly 10X the amount of capital they have. Quite simply, if they earn a good return above their cost of capital on that $100B, they will make a very nice profit in their business. Now, let's assume that they made some mistakes, and of the $100B they allocated, they lost $5B. That is only 5% of the amount they allocated. That is not a big deal, right? Wrong. While they only lost a small amount of what they allocated, they lost 50% of their net asset value of the entire business! Now they only have $5B of capital and, IF they are going to use the same 10X formula, they can only have $50B in allocations. So how do they get from the $95B they now have in capital allocated to the $50B they can comfortably have allocated? Brutally simple, they have to SELL $45B in assets to get there. Well, let's ask the question if Bank A is selling that much in assets, what is likely going to happen to the price of that asset? It will go down. Then let's compound the problem and say that Bank A is not alone in their mistake and Bank B, C, D and E all made the same type of investments. They also have to shrink the capital they have allocated by 50%. Now there are a lot of sellers and not many buyers, so the values go down. This creates more losses, which creates more need to liquidate capital, which creates more selling… Yes, it is that simple and yes it is that painful.

Let's look at it another way, if the five banks in the above example have all been forced to reduce their capital by $50B, what has happened? We have just pulled $250B from the overall capital base in the economic system. That is less money available for the system to function with, less blood supply for the organs of the body!

Now, we unfortunately have to get a bit more complex. Normally, when prices decline in this manner, assets get “cheap” and new buyers come into the market and buy the assets. This creates new demand which stabilizes prices. It would not take long for any of us to buy a brand new laptop computer if it was selling for $100. This is simply the law of supply and demand, but sometimes the normal rules do not apply. In this case, the laws are tested greatly because the assets in question are assets that are constantly changing in price and are dramatically affected by the rest of the moving parts in this dialogue. As should be abundantly clear to all by now from the press coverage, we are talking about sub-prime mortgages and the second and third derivatives of the same. When you add to the equation the close cousins to that type of lending and even mainstream lending that is being affected by an economic slowdown, what do you get? You get the liquidation of assets that, by the very result of the reduction in prices, are more and more impaired and are therefore worth less and less; and the cycle continues.

Hold on to your hats; you have to understand this next scenario in order to understand why the laws of supply and demand are not necessarily the same in this housing bubble scenario!!

The easiest example to give is a hypothetical pool of ten mortgages on one street. If all the borrowers on this street put 5% down on their home and they all paid the exact same price for their home, each house would have a 95% mortgage with 5% equity. Let’s assume that every borrower took out an adjustable rate mortgage on their loan. Naturally, they did not all borrow the money at the same time so they have staggered resets on their adjustable rate mortgage. So far so good?

Everyone is happy and making their nice low payment on their home, which has to go up in value, right? Well, the market begins to peak and prices just stay the same. Let’s say Home #1 has their adjustable rate mortgage (ARM) reset and they go to their lender and suddenly no lender will make a 95% mortgage anymore in that area. Now they cannot afford the payment and they cannot refinance. Now what? They put their house on the market, and it won’t sell for what they paid for it. So they lower the price 2%. They sell their house and lose 2% plus closing costs. Next, Home #2 has their ARM reset. They cannot afford the payment or refinance. They know that their home has declined in value so they are more aggressive. They sell their house for 5% less than they paid for it. Obviously, they have lost their equity, but at least they are out of the home and out from under that higher payment. What should become painfully obvious here is that the other eight homes also have no equity, and all of their ARM’s are going to reset soon. What is going to happen? They are going to go upside down and see their values go down enough to the point where they owe more on the home than it is worth. Everyone has seen this play out and should be thinking to themselves, “Surely the home prices will stabilize when they drop far enough.” That is 100% correct. The home prices will bottom at some point.

We are not talking about the home prices right now, though. We are talking about the MORTGAGES on these homes and what they are worth! These mortgages are now worth less than their face value. Many of the homes will go to default and the mortgages will be worth substantially less than the amount that was loaned. This is the KEY point that an investor must understand in order to make sense of what happened to liquidity in the market place!! If a bank owns one of those mortgages, or a pool of similar mortgages, or a derivative created from that pool of mortgages, the price is going down!

It is not a set price, either. It changes every time another sale takes place, and if the homes on the street keep declining in price, the value of those securities goes down more and more.

So what does this mean to the bank? It means they have to “write down” the value of the security. To bring everything full circle, the $100B that Bank A had in assets is now worth $95B and they have to liquidate assets. This leads to a reduction of asset values which creates more write downs, and the cycle perpetuates itself. Now we have the value of the securities impaired by the reduction in value of the underlying collateral (the home), but we ALSO have the value of the securities impaired by the laws of supply and demand. This is because there are so many assets for sale in the market. This is further compounded by the complex structures created by Wall Street when they packaged these loans together which created securities that pay back investors in a “waterfall” method which means that many of these securities will be worth absolutely NOTHING!

Now that all of our heads hurt, this is the root of the issue. The bubble in housing prices will deflate, and house prices will eventually find a bottom because they are a “real asset.” BUT the securities that were created to fuel the bubble may or may not ever bottom because they are potentially worthless. This domino effect has and will continue to reach a wide variety of securities that have nothing to do with housing. Those securities are simply being sold by “distressed sellers” who have to dramatically reduce the size of their balance sheets. The further by-product is that many businesses and borrowers will be unable to get new funding or will have to pay substantially higher rates.

All of the factors above reached a crescendo in mid-March with the near failure, and subsequent bailout, of Bear Stearns by the Fed. Simply put, they were in a liquidity squeeze which was compounded by the second simple cause for the rout—fear!

Investors heard that Bear Stearns was in potential trouble and they took their money out of the company. This compounded the problem listed above because if an investment bank has to send people their money, they are now forced to borrow or sell assets. If enough people want their money all at once, that creates a massive liquidity squeeze which the bank cannot address, and they are forced to take drastic measures. In this case, the drastic measures were a combination of a Fed bailout and a sale of the company for 80% less than its market value just weeks before. So, the near failure of Bear Stearns was caused in part by the credit crunch, but it was caused more by the fear of investors who started a “run on the bank.”

Business schools will study this case for decades, and there will be lots of theories of how this could have been avoided. The simple reality is that when greed overtakes common sense, and banks throw caution to the wind and rationalize making investments/loans because of the amount of short-term profit generated, bad things happen. There are many cases in history where this has occurred, and this is just another one added to the list.

Therefore, as a result of the lack of liquidity and the fear that overwhelmed the marketplace, asset prices, including stock prices, dropped precipitously in the first quarter. However, the problems we described were not completely ignored by the government. In dramatic fashion, the Federal Reserve and Treasury department “came to the rescue” with their attempt to provide the “blood” that the system needs—liquidity. With a powerful combination of lower interest rates and temporary lending to investment and commercial banks, the Fed is trying to give the system a transfusion to keep the organs from shutting down.

So far, it has worked and restored investor confidence as the market staged a dramatic rally from the lows. Only time will tell if the latest provisions from the Fed will be enough, or if the damage to the system is substantial enough to cause even more blood to be drained from the system. What we do know is that the overall root of the problem is not solved, and there will be substantial write downs yet to come. What we don't know and never know until after the fact, is whether or not the market has fully discounted the impact of the unwinding of the credit bubble.

So What Should We Do?

We have been talking about preemptive ways for investors to prepare for this type of negative environment for well over a year. The advice we gave was to focus on asset allocation and the risk tolerance in the accounts. We wanted to make sure that investors were prepared for volatility and would be able to stay the course if a problem occurred. Now that the correction has started, what should people do? It might surprise some, but the answer is the same.

Clients should be focused on their asset allocation and the risk in the portfolio. What may surprise a lot of people is that they may have actually begun to take a more conservative approach than they intended. This is what happens when there are large dislocations in the markets, and there are substantial differences in the results for various asset classes.

Let's take a hypothetical, and simple, example. If a client's asset allocation had grown to 70% stocks/30% bonds by January 1, 2007, and they took our suggestion to rebalance their portfolio back to a 50%/50% target at that time, where would they be now? Well, stocks have obviously sold off sharply, and bonds have been a fairly strong performer. By now, the client's allocation has probably moved to nearly 60% BONDS and 40% STOCKS. This is now a more conservative allocation than the client probably would like. Therefore, they should be selling bonds and buying stocks in order to get back to their target allocation.

The wonderful by-product of this rebalance is that now the investor is taking profits in what has done very well (bonds), and buying more of what is obviously less expensive (stocks). That wonderful Wall Street adage of "buy low, sell high" is actually being used.

Yes, we know this is overly simplistic, and everyone knows they should do this, correct? Maybe, but it is amazing how many investors will not take the steps necessary to take advantage of market volatility. The reason is fear. Just like so many investors did not rebalance by selling stocks a year ago, because of greed, now investors are afraid the market may go lower and are waiting to put money back to work. The whole principle of asset allocation is to force discipline on the investor and remove the emotions of fear and greed from the decision-making process.

So if you are wondering if you should begin to shift your asset allocation again, please carefully review your quarterly statement and then let us know when you would like to discuss.

Market Outlook

Our outlook remains cloudy for the markets. We have seen that the Fed, the Treasury and the politicians are all focusing on returning the "blood flow" back to the economy. Will they be effective? There is no way to know for sure, but our basic opinion is that they will fail to stimulate the economy in a significant way, and they may cause significant problems in the future.

While the stimulus packages we are seeing in the market may avoid some of the potential downside in the economy, there are still too many headwinds facing the financial system to completely reverse the downward trend in business growth over the next few quarters. We do not believe housing will bottom until well into 2009, and we are very concerned about the possibility of higher unemployment and corporate spending reductions. The U.S. consumer is still up to their eyeballs in debt and has a negative savings rate. Therefore, the consumer is unlikely to bail out the economy the way they have the last several slowdowns in this country. If you add to the equation the strong possibility that we are going to see higher tax rates on income and capital gains starting in 2009, we add another burden to the shoulders of the economic recovery.

The undesirable by-product of the massive attempts to stimulate the financial system is potential inflation. We are very concerned about the prospects for significantly higher inflation rates on the other side of this downturn. Higher taxes, higher inflation, a weak consumer and a cautious corporate spending environment could lead to several years of challenges for corporate profits.

Therefore, we remain very cautious about the outlook for the rest of 2008 and 2009. The good news is that valuations are not unreasonable and, in many cases, we are seeing very good valuations for companies that we like a lot. This should help mitigate the downside risk in portfolios and set up the potential for nice gains over the next three to five years. This is another reason to focus so heavily on the asset allocation process. All of these prognostications and forecasts are very opaque and difficult to pinpoint the action items imbedded in them. It is a much easier decision to say, "My target allocation is X, I am at Y, therefore we need to do…"

We have many exciting things happening at CAZ Investments and look forward to sharing those with you in our next quarterly letter. We apologize for the length of this letter, but given the material market moves, we felt you would benefit from a better understanding of what has transpired and what it can possibly mean for the future. We appreciate the confidence that you have in our firm, and our door is always open.

All our very best to you and your family.

Regards,

Christopher Alan Zook
Chairman and Chief Investment Officer