# INVESTMENT LETTER

A PUBLICATION OF CALDWELL TRUST COMPANY

| MARKET SNAPSHOT: OCTOBER 31, 2007 | DJIA: 13,930.01 | NASDAQ: 2,859.12 | S&P 500: 1,549.38 | 10 YEAR TREASURY NOTE: 4.48% |
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## CURRENT EVENTS

Sharp, short-term stock price movements are now a fact of life for investors. We just witnessed another bout in late October, fueled by the same dynamics we discussed in previous Letters—worldwide, minute by minute movement of massive amounts of capital using derivatives and employing leverage so that hedge funds and their ilk can magnify short term trading profits or losses. TV viewers can see this in action themselves right in their own homes by simply switching on the financial news channels. And, therein is part of the problem.

Legitimate investors who buy stocks seeking to earn higher total returns over a longer period of time can rightly be excused for being confused by some of what they see on these shows. Even the terminology has shifted away from more traditional investing terms toward jargon aimed at market day traders.

Now Fox News has announced that they will produce their own financial news channel. Their rationale is that the leading financial news channel has become much too cluttered with short-term issues that are of interest mainly to "Wall Street, not Main Street." If they remain true to their announcement, they will gear their messages more toward investors who are longer-term oriented and downplay the shorter-term factors that are of interest to traders, large and small. We wish them well and look forward to seeing what they come up with.

Meanwhile, it would be hard for anyone who is even casually interested in the financial scene to have escaped the media hubbub surrounding the impact of real estate mortgage market woes on our financial community. New wrinkles that have recently crept into the picture have added to Wall Street worries that lending losses could escalate into a more serious problem that also affects major financial centers in leading foreign economies. In past references to these issues, we have generally described the problems as serious but manageable. We still find little reason to change our opinion.

Another problem we have alluded to concerns "structured investment vehicles" (SIVs). These securities, concocted by Wall Street investment bankers, involve partitioning residential mortgages into separate pieces and then selling off those pieces to large, eager investment pools wanting to invest in what is most attractive to their own very specific needs. That is a very rough description, but it should suffice for our purposes here.

What remains unclear about this practice, even to leading bankers and our top federal regulatory bodies, is what to do about all these pieces when a sub-divided mortgage goes into default. There should be an obvious incentive to all concerned to re-structure bad loans rather than foreclosing and taking back real estate only to have to dispose of it at fire-sale prices. Doing otherwise would likely prove enormously difficult with many different investors trying to work out how to deal with many pieces of an actual mortgage—the old norm of one lender and one borrower to a loan having gone by the wayside. Our own take on this issue has been that its resolution could end up being a good thing for borrowers, lenders, and the financial markets.

Recently three of America's largest banks announced a plan to join in supporting the creation of, and willing participation in, a large "rescue" pool of capital. This new fund would help protect the banking system from incurring large capital write-offs that could endanger the faith and credit of banks in the minds of the general public. Regulatory agencies are almost certainly encouraging the creation of this capital pool and might even be mandating that the leading banks do so. The formation of this fund is actively underway and seems to be helping to calm investment markets.

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Here are a few things we would like to mention again regarding this whole market episode …

One is that even the major central bankers now admit that they can't calculate the magnitude of the risks these Wall Street cleverly constructed new securities have created. Nobody knows exactly what they are, how much money has been invested in them, or where that money is actually coming from.

Another is derivative usage, long one of our concerns. Derivatives allow investors to arrange huge borrowing leverage, and even our brightest and best informed banking regulators have no way of knowing how massive the total capital involved actually is. Nor can they know how much borrowing these back-door schemes have created. As a result, central banks no longer control this credit creation as they do the ordinary bank loans most of us are familiar with and understand. This erosion of control over large scale credit creation must be worrisome to those central banks as well as to us in the general public.

Lastly, shares of America's leading public companies continue to trade at substantial discounts from the values they should fetch based on company fundamentals. Warranted market values are calculable based on the strength of company profits, growth, and prospects within the economic climate then existing. This discount continues to trouble us and others in our field because, inexplicably, it is so much bigger as a percentage of the current share price than it should be by any rational standard.

To the extent that the present loan crisis leads to changes or new rules that remove some of the existing rampant speculative aspects, from our vantage point the outcome could actually bring good news to long-term stock investors. The confidence generated by the correction of such excesses could encourage the present discount to begin to remedy itself. We can only hope so.

## CONCLUSION

**In the face of these issues, the key for investors now is to focus on how stocks perform over the coming months after withstanding two recent bouts of massive, short-term selling by Wall Streeters. These episodes, in which 500 points or more get shaved off the popular Dow Jones Industrial Average in a matter of hours, seem to happen for no obvious or understandable reason other than short-term greed.**

**We are well aware of some of the weak areas in our present Economy and with some giant companies as we plod through some softening, both here and in our trading partner nations. It used to be said that when America sneezed, the rest of the world caught a cold. The good news, however, is that in the past few years new markets outside the U.S. have in fact helped to hold up our own Economy as consumer demand and corporate expansion in formerly backward countries offset sluggish growth in our own, now more mature Economy.**

**Our advice continues to be to stay the course. Hold on to stocks of solid, well-managed companies that have aggressive international operations and exposure, and hope that in the end the credit problems we are now working through prove to be more of a positive than a negative, as we believe they will.**

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