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The Jargon Jungle

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as concern about sub prime mortgages grew. Then in June some investors demanded their money back and the hedge funds had trouble liquidating securities at favorable prices. Their lenders (other Wall Street investment banks) threatened to sell the collateral unless Bear Stearns provided additional security. Merrill Lynch was on the verge of seizing $800 million of CDO collateral when Bear Stearns decided to inject $1.6 billion of its own capital into its High-Grade Structured Credit Fund. Other hedge funds also suffering financial losses from their CDO exposure include UBS's Dillon Read Capital ($124 million), a British fund, Queen's Walk Investment ($91 million), and Caliber Global Investment (liquidating its $908 million portfolio due to unspecified losses).

We think a key problem has been a lack of transparency in pricing CDOs. They are complicated instruments which do not trade actively. Consequently industry pricing practice has been to "mark-to-model" rather than "mark-to-market". In other words, in determining the market value of their CDO holdings at quarter end, holders use financial models to estimate the value.

The potential conflicts of interest are very obvious for hedge funds but present as well for other investors such as pension funds and financial institutions. All investors prefer to see the value of their investment go up. This preference is particularly acute for hedge funds which receive a fee based on the net asset value of the portfolio plus a large incentive bonus on any profits earned. Now that some CDOs have faced the stern discipline of a market sale, market participants are beginning to recognize the "flaws of optimism" in their financial models. We expect to see many more difficulties with CDO investments, especially those backed by sub-prime mortgages.

Summary

The yen carry trade is an artifact of Japan's manipulation of the yen's exchange value. Government authorities believe a weak yen makes Japan's export industries more competitive. The yen carry trade, however, exacerbates global trade imbalances and fuels speculation in global securities markets. We predict its trading partners will pressure Japan to raise its interest rates into better alignment with that country's improving economic fundamentals. So at some point the yen carry trade must reverse. We will make every effort to be prepared for that inevitability.

The collateralized debt obligation market faces increasing stress. The probability of a "financial accident" of some kind is growing. We think the financial sector (in particular investment banks, money center banks, super regionals) is vulnerable to the fallout from any widespread hedge fund industry problems. Consequently, we have maintained an underweight position in that sector. We will continue to monitor closely developments in the CDO market and their impact on the financial markets. After all, it's a jungle out there.

PATTON ALBERTSON & MILLER LLC

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A QUARTERLY MARKET COMMENTARY & NEWSLETTER PUBLISHED BY PATTON ALBERTSON & MILLER, LLC

Patton Albertson & Miller Ranked 5th in the United States

Financial Advisor Magazine in its annual survey published in the July, 2007 issue named Patton Albertson & Miller the 5th fastest growing registered investment advisory firm in the United States and number 1 in the state of Georgia. The survey was a ranking of independent investment advisory firms with assets under management of between $100 million and $300 million and was based on their percent change in assets under management between December 31, 2005 and December 31, 2006. Our growth rate for 2006 was 86% and we ended the year with $158 million of assets under management.

As we said last year when we were ranked 17th in the survey, we have never focused on growth but rather on quality of service. What is particularly satisfying about this measure of our success is that nearly all of our new clients are referred to us by other satisfied clients or other professionals with whom we work. Rarely do we make cold calls. Put another way, we believe our growth is a natural result of superior service and not the result of slick marketing or aggressive sales techniques.

– Jimmy Patton
Patton Albertson Miller, LLC

Office Update:

We are pleased to announce that we have moved into new office space in both Macon and Atlanta. Please make note of our new address in each location. Also, please make note of our new phone numbers in Atlanta.

Atlanta Office

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Phone numbers in Macon remain unchanged.

Healy Capital Management clients:

Former Healy Capital Management clients can reach John Healy at our Atlanta office number (404) 917-2727 or our toll free number (866) 606-5554. Please make note of his new number.

The Jargon Jungle

by Bill Miller
Patton Albertson & Miller, LLC

The word "jargon" comes from the Old French *jargoun* meaning a "warbling of birds." In our language it maintained that sense of "twittering" or "chattering" until the middle of the 17th century when it took on its modern sense of "the specialized language of a trade, profession, or group." The investment jungle teems with an abundance of jargon, so we thought it might be helpful to discuss two species our clients might have encountered recently: "yen carry trade" and "collateralized debt obligation".

We should quickly note that we have never engaged in the "yen carry trade" nor have we ever purchased a "collateralized debt obligation". We bring these terms to our clients' attention because the investment world is too interrelated nowadays for us to ignore them.

The yen carry trade impacts our investment strategies by elevating global stock market valuations thus reducing the number of attractively priced stocks. At the same time, the ample liquidity it supplies has suppressed interest rates and narrowed credit spreads making our job on the fixed income side more challenging.

Problems surfacing in the massive collateralized debt obligation market also impact our strategies. We will see that high leverage coupled with opaque pricing is a recipe for trouble in the hedge fund universe. We believe there will be repercussions throughout the investment world.

YEN CARRY TRADE

The term "yen carry trade" refers to a transaction in which a person exchanges Japanese yen for another currency and then invests it in assets denominated in that currency, typically marketable securities such as bonds or stocks. What would prompt such a transaction? For a Japanese investor the reason is the abysmally low level of interest rates in her country. Japan's equivalent of our Fed Funds rate is currently just 0.50%. Imagine investing $1000 for a year and only getting $5 of interest!

Interest rates are substantially higher outside Japan so Japanese savers have a strong incentive to invest abroad, and they have done so by converting their yen into such currencies as U.S. Dollars, New Zealand Dollars, Icelandic Krona, and Brazilian Reals. Conservative by nature, Japanese savers have favored investing in government bonds, but another group of yen carry traders has been much more aggressive. Global hedge funds quickly realized they could borrow yen practically for free, convert it, and invest the proceeds in stocks, bonds, and real estate — on a leveraged basis of course.

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For example, a hedge fund might raise $10 million from accredited investors and then borrow in yen the equivalent of another $90 million for one year at an interest rate of, say, 1%. The hedge fund then invests the $100 million in U.S. Treasuries paying 5% interest. Voilà! It earns the following after one year:

Hedge Fund Yen Carry Trade

Interest earned on $100 million @ 5%= $5.0 million
Less financing on $90 million @ 1%=$0.9 million
Hedge fund gross profit=$4.1 million

Management share of $4.1 million profit @ 20%=$0.82 million
Asset management fee on $10 million @ 2%=$0.20 million
Total hedge fund management compensation=$1.02 million

Investors' profit after management compensation=$3.08 million
Investors' return on $10 million investment=30.8%

Everyone appears to benefit. Investors make 30.8% even though the hedge fund invested in risk free U.S. Treasuries. The hedge fund managers also do exceptionally well, earning $1.02 million (before overhead expenses) from a simple investment strategy. More daring hedge funds might invest in high yield bonds (junk bonds), emerging market securities, or real estate in order to achieve even more spectacular returns. Indeed, the expansive Japanese monetary/ currency policy has flooded the world's securities markets with cheap liquidity. Many observers cite the yen carry trade as a key factor in global bull markets and the merger and acquisition boom.

But there is a catch, a potentially devastating one: the exchange rate between the yen and the dollar. Remember the $90 million came from the conversion of yen. Using the current exchange rate of 123 yen to the dollar, the hedge fund borrowed 11.070 billion yen on which it promised to pay 1% interest or 0.1107 billion yen. Our example implicitly assumed the exchange rate did not change. But what if it had?

Suppose the yen weakened against the dollar to 130. Then only $86.0 million would be needed in order to have enough yen to repay the loan ($86.0 million times 130 yen/dollar equals 11.180 billion yen). The hedge fund would earn a windfall $4.0 million from being able to repay the loan in depreciated yen. Investors and managers would be ecstatic. Yen carry players in recent years have been exactly in this wonderful situation because of the yen's relentless weakness. Is it any wonder so many investors participate in such a bonanza?

The other side of the coin gets overlooked in the euphoria, but we know one day it will come up. Suppose the yen appreciated from 123 to 117.7. The entire $4.1 million profit would vanish due to the unfavorable shift in the exchange rate. A mere 4.5% adverse move in the yen would sink the hedge fund's strategy. A sharper appreciation in the yen would cause outright losses which, of course, would be magnified by the leverage of the hedge fund.

Few investors would participate in the yen carry trade without great confidence that the yen would not appreciate significantly. Fortunately for them, Japanese authorities misguidedly have maintained an extremely low interest rate policy in recent years in order to depress the yen and thereby encourage Japan's export industries. Whenever the yen has rallied temporarily, Japanese spokesmen at the Bank of Japan or the Ministry of Finance have been quick to express displeasure. Such assurances have provided a greenlight for continuation of yen carry investment strategies. Although no consensus exists concerning the size of the global yen carry trade, estimates range from $200 billion to over $2 trillion. The yen carry trade has undoubtedly provided a key propellant to the soaring financial markets around the world.

We believe the yen must appreciate 20 to 30% versus major currencies such as the Euro and the dollar in order to restore global trade equilibrium. We don't know how or when realignment will take place. We do know it will force the unwinding of leveraged yen carry trades, and that in turn will cause fireworks throughout the world's financial markets.

Collateralized Debt Obligations

Collateralized debt obligations (CDO's) are investment grade securities backed by pools of lower credit quality debt obligations. In a CDO the credit risk is divided among different tranches by applying the cash flows from the entire pool first to the "senior" tranche (rated AAA, the highest credit rating), then to the "mezzanine" tranches (rated from AA down to BB), and finally to the "equity" tranche which is unrated. It is a miracle (if that is the correct word) of modern Wall Street finance that by "slicing and dicing" the cash flows from a pool of non-investment grade debt, ie. junk, a portion of it can be transformed into investment grade paper.

Under this structure, any credit losses are borne in reverse order of seniority which is why some critics refer to the equity tranche as "toxic waste" since it bears all the initial losses. Typically the underwriter (a Wall Street investment bank or mega-bank such as JP Morgan Chase or Bank of America) and the asset manager (usually an affiliate of the underwriter) retain a portion of the equity tranche and sell the rest to aggressive investors.

The tranches carry coupons commensurate with the perceived level of risk. The senior tranche receives the lowest coupon while the equity tranche receives the highest. But even the senior tranche receives a higher coupon than available on a traditional triple-A obligation. With the world awash in liquidity, partly due to the yen carry trade, investors have snapped up any incremental yield they could find with alacrity. The boldest investors purchase the much riskier equity tranche to receive a double digit coupon as compensation for their subordinate credit position.

CDO's have been extremely popular as evidenced by their annual issuance: $157 billion in 2004, $273 billion in 2005, and an astounding $550 billion in 2006 (Source: Securities Industry and Financial Markets Association's *Global CDO Market Issuance Data*). That is nearly $ 1 trillion of CDO's in the past three years. Investors in CDO's include insurance companies, pension funds, banks, and (particularly at the more junior tranche levels) hedge funds. Provided the credit loss experience of the underlying collateral pools match expectations, all investors are happy. Unfortunately, in recent months experience has begun to diverge from expectations.

Many of our readers have seen the news reports about Bear Stearns' CDO debacle. An investment subsidiary of that venerable Wall Street investment bank ran two large hedge funds which invested in collateralized debt obligations backed by sub-prime mortgages. These are mortgages with significantly below average creditworthiness whether due to high loan to equity ratios, scanty financial data on the obligors, or other negative considerations. The hedge funds leveraged their investors' capital and pledged the CDO's they purchased as security for the borrowings.

The hedge funds began losing money this spring

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Risky Signs

We see signs that risk is rising in the financial markets. Consider the recent public stock offerings of giant private equity firms Fortress Investment Group and Blackstone Group. Kohlberg Kravis Roberts & Company has announced plans to come public as well. Like the odd behavior of wild animals prior to a severe storm, the fact that leading private equity firms are deciding now is a good time to sell shares strikes us as portentous.

Essentially, private equity firms profit by managing pools of capital that buy entire public companies. After taking control, a private equity firm typically brings in new management to improve operations, close facilities, and reduce headcount. Wall Street investment banks finance the acquisition with debt based on the creditworthiness of the company being acquired. For instance, Kohlberg Kravis Roberts & Company (KKR) is buying First Data Corp, the financial transactions processing firm, for $29 billion. KKR is only committing $7 billion of equity capital; the remaining $22 billion will come from junk bonds and bank loans. The hope for this transaction and others like it is that, after 3-7 years of restructuring, the company can be brought public again at a significant profit.

Major companies like Hertz, Dunkin' Donuts, and Burger King have been taken private. While these deals used to be called "leveraged buyouts" or "LBO's" today we mainly hear the term "buyout", an indication of complacency about the risk of high debt levels. The private equity universe of target companies now encompasses most of the S&P 500. Private equity firms' aggressive use of debt reflects its easy availability and low cost — thanks in no small measure to the flood of global liquidity from the yen carry trade.

Due to a strong economy and loose lending standards, private equity capital has mushroomed. Last year a record $156 billion of new private equity capital was raised, about the same amount as the net inflows to equity mutual funds. The buyout industry now has approximately $400 billion available to invest. With leverage comparable to the First Data deal, that $400 billion could represent perhaps another $1.2 trillion in buying power. In comparison, the entire U.S. mutual fund industry controls $6 trillion.

Thoughtful observers know that the greatest threat to private equity's continued prosperity is a contraction in global liquidity. In our judgment, the Blackstone partners' decision to sell 12% of their firm for $4.1 billion suggests that those shrewd, thoughtful men recognize the credit boom is in the late innings. Perhaps they sense private equity firms are near their "peak earnings", and like all cyclical businesses, the time to sell them is when prospects look best. Perhaps they can see storm clouds on the horizon.

Fed Policy: *Still on Hold, But Are Changes Coming?*

by Charlie McAnally
Patton Albertson & Miller, LLC

The Federal Reserve's monetary policy arm, The Federal Open Market Committee, just concluded its June 28th meeting. As expected, the FOMC decided to keep its target for the federal funds rate at 5-1/4 percent. It has now been a year since the FOMC last moved its target. Since then, market participants have experienced several waves of optimism that a reduction in the fed funds target was imminent, only to have their hopes dashed. Even the slow growth during the first half of this year, with real GDP growing at less than 1% on annualized basis in the first quarter, failed to compel Fed action.

The Policy Statement released at the end of the recent meeting reiterated the Fed's belief that "…the economy seems likely to continue to expand at a moderate pace over the coming quarters." What the FOMC means by "moderate" will be clearer when Fed Chairman Bernanke gives his semi-annual Monetary Report to Congress on July 18. At February's meeting, his forecast was for real growth to be between 2-1/2% and 3%. Economic reports released after the FOMC meeting, such as the Employment Report, the manufacturing and retail reports from the Institute for Supply Management, and Factory Orders, do suggest the economy is regaining momentum in spite of the ongoing adjustment in the housing sector.

Concern over inflation has kept the Fed on hold despite the modest improvement in the inflation data in recent months. While the Fed acknowledged in its latest Policy Statement that

> "…readings on core inflation have improved modestly in recent months", it also stated that "…a sustained moderation in inflation pressures has yet to be convincingly demonstrated. Moreover, the high level of resource utilization (like the aforementioned strong labor report) has the potential to sustain those pressures. In these circumstances, the Committee's predominant concern remains the risk that inflation will fail to moderate as expected."

Such language disappointed those that thought a reduction in rates might occur soon; especially those that thought the mortgage market's problems were worse and more widespread than the consensus view. But so far, such fallout appears to be limited and contained. The futures market currently is not pricing in any meaningful reductions in the federal funds rate until the first quarter of 2008.

Bill's article mentioned the abundance of jargon in the investment world. The Fed has one called "core inflation." It refers to the reported inflation number (more jargon — this is usually called "headline inflation") minus the impact of food and energy. Thus you'll read reports that "headline inflation" was up 2.5% in the last year, but only up 2.0% "ex food and energy". This sounds odd and seems to fly in the face of reality (some wags suggest that if you don't eat or drive then inflation isn't a problem!).

The rationale for excluding food and energy prices centers on their historically high monthly volatility. Such volatility tends to mask the underlying inflation trend. Alan Blinder, the Fed former Vice Chairman, once said "The key question on my mind was typically: What part of each monthly observation on inflation is durable and what part is fleeting?" "Core inflation", understood in this way, supposedly represents the underlying trend in inflation, once transitory swings have been smoothed out. A disconnect between measures of "headline" and "core inflation", however, could become a concern for policy makers.

Over the past year, in fact, the Fed has been engaged in an internal debate concerning changes to its inflation methodology, the adoption of a more formal inflation target, and just what that target might be. We hope Bernanke will discuss what the Fed is considering when he meets with Congress on July 18. Any meaningful changes to how the Fed views inflation and the outlook for inflation could have a dramatic impact on the financial markets both here and abroad.