WESTERN RESERVE
CAPITAL MANAGEMENT

July 25, 2008

"Buy-in" of a Lifetime

In the *seventies*, oil trader Boone Pickens mused he could buy oil production cheaper on Wall Street than he could buy oil wells. This is not unlike the amazing "arbitrage" opportunities of any emotionally charged market. Today, one can buy the core of America (mortgages and financial stocks) cheaper on Wall Street than on Main Street. This is a fact. In large part, new accounting rules and massive momentum shorting in housing related and financial firm investments has created a gulf between the write-downs, slam-downs and reality. The ability to buy well managed financials on Wall Street at ridiculous discounts to Main Street exists and, in our estimation, is a once in a lifetime opportunity.

A Flawed Premise

The New York Times, whose writers have struggled in the past to deduce fact from fiction, gets kudos for breaking their trend and getting it half right in a recent article entitled "Are the Bean Counters to Blame? (Article attached for your review). The article referenced some of the problems with accounting rule FAS 157 (FAS 133 for credit insurance derivatives) and how this rule is amplifying and thus distorting the losses and write-offs in financial assets like residential and commercial mortgages and, therefore, financial stocks. The crux of the issue does not lie in FAS 157 itself. Yes, this accounting treatment is flawed. But it's the application of this new accounting treatment by the accounting profession that is well off the mark and the crux of the problem.

The FASB (Financial Accounting Services Board) devised rule 157 (and rule 133) in an effort to prevent future frauds like Enron. They created a new set of accounting standards that require "mark to market" accounting of private placement investments to a liquid secondary market. This "liquid secondary market" does not exist and thus is the inherent flaw in their logic and methodology. Nevertheless, the accounting profession began to explore how companies could "meet" the requirements of 157/133 just as the sub-prime mortgage crisis erupted last year. For lack of a "real" secondary market, auditors imprudently began "marking" financial assets to newly created 2006 credit insurance indexes. These indexes were **NOT** designed for the accurate and efficient "marking" of cash assets. They were created as an "option" market for speculators who pressed Wall Street firms for ways to "play" the obvious direction of the U.S. housing market. These indexes were designed to perform just like option markets and therefore are highly volatile and intentionally exacerbate the magnitude of underlying cash market securities through excessive leverage. What all of this amounts to…. is an unintended distortion of credit and loss. This distortion has produced a tsunami of non cash write-downs of perfectly performing credits that are held by very solvent financial firms and within very solvent credit structures such as CDO's. This is likely to result in tens of billions of dollars of write-ups of performing securities in the future across Wall Street. **The application of these new FAS standards against non cash markets overstates the nation's credit crisis by as much as five fold. This has resulted in financial stock and financial asset valuations that are at *eighty-year* lows. We think these valuations are absolutely remarkable and yes… a once in a lifetime opportunity.**

The Data Distilled

The two most well known of the credit insurance (option) indexes are the ABX-HE (securitized sub prime home equity loans) and the CMBX (commercial mortgage-backed securities). The ABX-HE indexes price-in catastrophic loss assumptions that we believe are an utter and complete exaggeration. Even a firm (which we do not own) as disadvantaged as a Washington Mutual *e.g.* (due to the types of mortgages and locales) will see cumulative losses of less than one-half to one-third the losses implied by the ABX-HE mark downs. To date, the financial services community (banks, brokers and insurers) have taken approximately $500 billion of write-offs (under FAS 157/133 marked to the ABX-HE) against domestic residential mortgages and related securities. This is 5% of the value of all domestic mortgages ($10 trillion), an impossible outcome. To put 5% into perspective and assuming a dramatically inflated 30% decline in home prices nationwide coupled with an equally pessimistic 10% equity in mortgages foreclosed upon; $500 billion in absolute losses implies that $2.5 trillion of mortgages will go into default. This would equate to one in every four American homes [$500 billion/20% = $2.5 trillion]. **There is no conceivable way one in four Americans are about to lose their home in foreclosure. Some pundits even use a $1 trillion dollar write-off figure which would equate to one in two Americans losing their homes.**

The actual performance of the ABX-HE collateral versus the option market pricing of the individual series says it all.

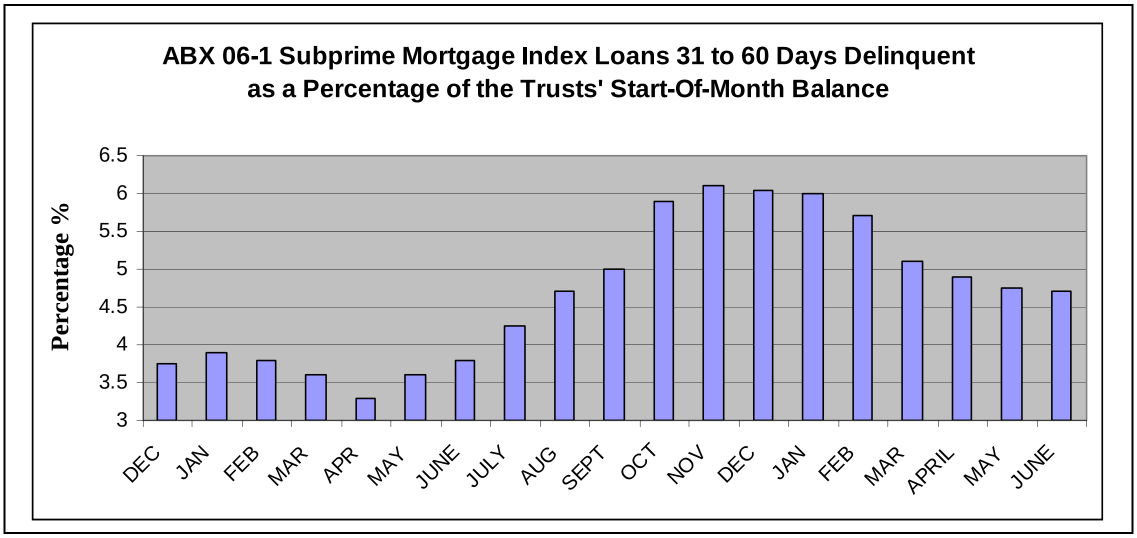
	Implied Cumulative Losses per Index	Actual to-date Losses	Our Estimate for Cumulative Losses
ABX-HE 06-01	22%	2%	8%
ABX-HE 06-02	29%	3%	9%
ABX-HE 07-01	41%	1%	10%
ABX-HE 07-02	45%	1%	12%

More telling than the statistics above is that over half the original principal balances of the two 2006 series collateral has paid-off (refinanced) or been charged-off already. So, how can the losses leap to 29% *e.g.* in the 2006-2 series if we are at only 3% to-date with only 14% in non-accrual and >50% paid-off already? **Answer: it can't.** Even if one assumes no abatement in new delinquencies and 100% loss on the 14%

remaining in non-accrual. Eighty percent of the mortgages remaining would have to default in order to reach the losses that the index implies.

(Note: delinquencies are falling-off… see Chart below)

Put simply, the speculators driving these dynamics are not doing the math; they merely have "jumped" on a trade too aggressively and have distorted prices relative to reality *i.e.* a "bubble".



Source: Western Reserve; Issuer 'trust reports'

As the chart above illustrates, the "roll rates" for new early-stage delinquencies peaked last winter. What fundamentally has taken place in the ABX-HE collateral pools is that the peak delinquencies experienced late last year essentially "flushed" out the speculative players in the housing market. What remains are the lower risk of default owner-occupied borrowers (people who actually live in the home and will fight hard not to lose it). Declining early-stage delinquency, significant pay-downs, pay-offs and refinancings all coupled with speculators getting flushed out spells a peak in mortgage losses and at a level materially below the current mark-downs by several fold.

A significant distortion is also taking place in the commercial mortgage-linked CMBX index. The two worst *post* Depression commercial mortgage vintages are 1974 and 1986. Cumulative losses on the 1974 commercial real estate credits were 7% and on the 1986 vintage (the worst that anyone still alive has ever experienced) were 9%. The current CMBX pricing suggests losses on 2005-2006 commercial mortgages to top 15%. This index projection is a complete disconnect from reality. **The underlying collateral of the CMBX has non-accruals of LESS than 50bp thus far.** To extrapolate a 15% loss from <50bp of non-accruals is not an index that is linked in any way to reality. **Massive write-ups are inevitable…**

As an example, Citigroup, which the Fund has recently acquired at prices ranging from $15.30 to $16.20 has taken nearly $30 billion in write-offs, most of which relate to residential mortgages. Citigroup's whole loan portfolio of sub prime mortgages has to-date 8.5% non-accruals. When these same loans are securitized and held by Citi as "securities" like RMBS and CDO's of RMBS; they are priced reflecting 20% to 40% losses (per ABX-HE "marks"). This highlights the massive distortion taking place when applying FAS 157 to an "options" market and not to realistic stress-tested discounted cash flows. Citigroup trades well below book value; the significance of which is greatly understated by the accounting distortions of the ABX "marks". Without a doubt, this distortion of true valuation *via* these new accounting rules has created an unparreled opportunity in financial stocks. This is especially true in smaller capitalization financials where we have a deep and extensive expertise. Most of our long capital is invested in small cap financials which are experiencing record low valuations, record high short interest and excessive and illegal naked shorting. We suspect this combination of variables has positioned our portfolio very favorably.

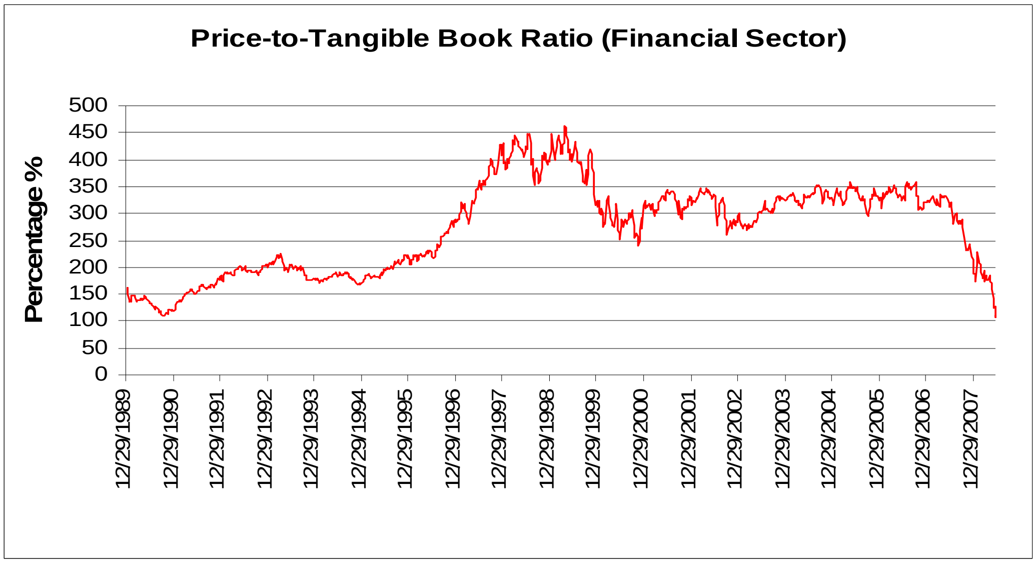
SO, HOW DOES TODAY'S CREDIT CRISIS COMPARE WITH THE ONE I EXPERIENCED AS A REGULATOR ON THE FEDERAL RESERVE'S STAFF IN 1990-1992?

ANSWER: IT'S NOT EVEN CLOSE!

Today, our banking industry's average non-performing loans plus foreclosed upon property (OREO) known as nonperforming assets or NPA's is about 60 basis points or one-fifth where NPA's stood in 1990. Conversely, today's risk-weighted capital ratios are at three-times the 1990 level. So, this crisis is more of a liquidity (panic) crisis than a really deep credit crisis. IndyMac Bank which our fund has never owned failed last week. What I found interesting (and Senator Schumer may find expensive in the form of potential lawsuits) is that IndyMac is the first U.S. bank to fail with an NPA ratio less than 50% of capital. To make the FDIC's watch list, an institution must have an NPA ratio (pre-risk weighted) approaching 100% of capital. IndyMac was taken over by regulators at less than half the FDIC's "watch list" criteria. According to IndyMac's primary regulator, it failed without being on the watch list because of the comments made by the NY senator. There are ninety banks on the FDIC's "watch list" today. When comparing the ninety banks on the watch list for potential failure today to the 500+ banks that were on the same list under the same definition in 1994… one must ask oneself….what the hell are we doing to our financial system in this country? **Only 1% of the banks on the FDIC's watch list in 1994 actually failed.**

The Opportunity

Where are valuations? The regional banking index reached a *post* Depression low of 0.6x book value early last week before a wicked short covering rally ensued. The accompanying chart is the banking sector's price-to-tangible book ratio. This too suggests valuations are at or below the crisis that troughed in 1990. As previously mentioned, problem loans are one-fifth and capital ratios are three times where they were in 1990. Deep value investors would be wise to take this very seriously.



Source: Stifel Nicolaus

This is the "buy-in" of a lifetime. The nation's credit issues are NOT this severe. Only narrow slices are severe and the Draconian and ubiquitous misapplication of new accounting standards has caused a baseless distortion of the credit picture of many of the nation's financial institutions. We have been duped into believing the solvency of our financial system is truly at the brink of destruction when the math gets you nowhere even close. Who is to blame? The bean counters who messed-up the accounting? The speculators who have over shorted (some illegally) the financials? Wall Street which created the ABX/CMBX out of greed? The political opportunists in Washington? WHO CARES? I don't…It's a gift!

The fund is flat year-to-date as of this writing and we continue to buy into weakness amid the greatest panic in American financial stock history. **The financials rallied over 800% off the 1990 trough by 1998. I see a 1,000% run over the next decade off these lows.** The heightened level of short interest alone that we see in financial stocks is a powder keg for a rocket ship ride north like we have never seen before. Investors should care less who caused it or why. They also should care less about near term price volatility. They should simply want to get involved in this sector. The rewards are ten times the risk… and that risk can be mitigated easily by avoiding the financials truly at risk to a liquidity panic.

Regards,

Michael P. Durante
Managing Partner