WESTERN RESERVE
CAPITAL MANAGEMENT

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Response to the Treasury or "Paulson" Plan

Partners,

The Fund is experiencing a double digit profit in September as of the President's speech last night. Extreme volatility is to our favor given our deep discount valuation bias, our focus on quality, and our deep experience in the financial sector which is a key component in our strategy. Like most fund managers, we have been fielding many phone calls over the past two weeks and now that we have some "meat on the bone" behind the combined Treasury and Federal Reserve actions to stem the country's liquidity crisis; a more formal response relative to the Fund is appropriate.

For over a year, we have been calling for the banking and capital markets regulators and the Congress to address mark-to-market accounting ("MTM") inefficiencies. This has now been forced upon them by an eruption and disruption to our credit markets not seen since the Great Depression. We were gratified that even a few congressmen and woman, who clearly don't have much understanding of MTM, started asking questions about it this week. Finally!

Accounting didn't get our country in this jam. Some ridiculously lax underwriting standards in the residential mortgage arena did. However, the "real" credit problems facing our country's banking and financial system are pale in comparison by many multiples to the exacerbation caused by MTM. Refer to our mid-year client letter from July to review. The average federally insured bank has only 0.7% in seriously troubled bank loans. That is hardly a substantial systemic credit crisis. In fact, it's about one-third of the last crisis that peaked in 1990 when I was a young bank examiner with the Federal Reserve. MTM makes it appear to be about five times this size. So, let's bring-in the bean counters…

As the mortgage crisis has passed peak already (not over, just passed its peak), it's dispiriting that the crisis now is liquidity and the sole culprit MTM. Many Americans now can't get a car loan or a small business loan or any type of credit and this, of course, has absolutely nothing to do with sub prime mortgages. The mortgage debacle was and still remains relatively focused and manageable on a "cash" accounting basis save a few institutions that went over the top like Washington Mutual *e.g.* whose fate is and should be uncertain. But what of the rest of the financial system? MTM has crippled our entire credit system now and this is what the Treasury Plan ("Plan") put forward by the now reluctant TV stars Hank Paulson and Ben Bernanke attacks. We might have used the word "addressed", but we are at war. Warren Buffett called this a "financial Pearl Harbor". The Plan is an attack. A counter-attack against MTM.

Pundits across Wall Street, TV and popular print media keep referring to the Plan as a "bail-out". They are missing this by a country mile. Federal Reserve Chairman Bernanke first questioned MTM as a credible accounting of "fair value" during the Bear Stearns' asset sale to JP Morgan last spring when he hired bond manager Blackrock to value Bear's assets. What Bernanke was saying (and few were listening as we were) was that the Fed's *de facto* purchase of Bear's assets was going to be based upon intrinsic value (discounted cash flows) and not GAAP's MTM. He even mentioned this specifically a few days later in a speech before the Richmond (Va) Economics Club to no "catch-on" by the media.

The Plan is a broader version of the Bear Stearns structured asset purchase. It was never a "bail-out". If it was a "bail-out" then who paid up? Bear's stockholders? JP Morgan? No. The Fed paid "fair value" for assets, if held through the crisis of confidence will pay-out at rates considerably better than the accounting mark-downs implied. It was a discount asset acquisition and we immediately bought shares in JP Morgan that day in your Fund. The market missed the point and we were able to buy more JP Morgan again throughout June and July at even more favorable prices (some below book value) and we thank all those who sold bank stocks ubiquitously in the panic this past summer.

Bernanke used the term "mark-to-maturity" in his prepared speech before the Senate Banking Committee this week. It appeared by the Q&A that not a single senator seemed to have a clue as to what he was talking about (we may need a new Senate Banking Committee). **The Plan is NOT a "bail-out". It's the government stepping-up to "make a market".** There is no market on Wall Street because of MTM tortuosity now and what the economy needs is a "market maker". And market makers (those who step-up with capital in crisis) usually make reams of money if history is a guide.

It's no surprise to us that more and more financiers agree as we do with Hank Paulson that the government is very likely to make a ton of money off of Fannie Mae, Freddie Mac, AIG and now the Plan. Does any of that sound like a "bail-out"? Even the President, in his folksy language, made mention in his speech last night that the government now appears to be the only institution which possesses the "patience" to buy mortgage-based assets, which as he put it are severely under valued. MTM is the new "buzzword" suddenly. And only those who are short financial stocks *en mass* think it's accurate. Well, there are few academics that think so too, but they invented MTM in a cubicle somewhere far removed from the real world.

A recent Goldman Sachs survey of the largest hedge funds suggests that the only sector that most funds are net short are financials; and it's substantial…almost 25% net short. **We estimate hedge funds eventually will have to "cover" as much as $1**

trillion in financial stock shorts just to get back to neutral on the sector. This is all to our benefit; and imagine if some start to go net long!

Bernanke said it about as plainly as a Fed Chairman could. Most of the nation's banks are reporting materially under valued balance sheets. We know all too well what Ben is talking about. We are long several small cap financial names in the Fund that have negative book values under GAAP MTM, yet have experienced no credit deterioration and no cash flow impairment. We'd like an explanation of what "negative book value" means by a rational accountant. MTM robs us all of patience because it distorts values. These longs we mention have as much as 50% of their stock borrowed short by folks that we must presume believe GAAP is accurate.

The Plan is about two things – making a market that has rational pricing intentions and (as the President said) "patience". This crisis is self solving if we can inject a little patience.

The Plan, in effect, should rid us of the shackles of MTM and option-like market "marks" driven by gamblers in the ultra thin ABX, CMBX and CDS markets (which aren't actually markets as they are pure OTC and unregulated). As stated before, we take no issue in these highly levered "option-like" derivatives. Advanced capitalism should offer many ways to *skin a cat* with varying degrees of risk-to-reward. However, accounting is not an "art" as one public audit firm recently opined in a white paper regarding FAS 157 *et al* or MTM. It's a science. Accountants are awarded degrees that are science degrees…not arts degrees. "Fair value" has never been a spot-in-time empirical. It should never be tied to these highly speculative and most apt to display distortion pricing instruments. They should never have been tied to MTM by the audit community searching desperately for an "observable input" under Level II FAS 157, which is the root cause of the liquidity crisis. A new, unbiased market-maker will now be able to set rational prices (barring a highly unlikely congressional blow-up). Ben Bernanke understands "fair value". It's dreadful that he has to show us what it means by force.

In the Fund, we were aggressive buyers of numerous financial stocks in the desperate days in late June and early July. Without getting into a lot of detail, we were looking for "safety and soundness" factors in our selections relating on both qualitative and opportunistic levels.

One, we required that they have adequate capital and reserves or "primary capital" well in excess of potential problem assets in order to ride out both the "real" credit crisis (fair market or intrinsic value) and the surreal MTM storm. This didn't mean we excluded financial firms with obvious credit issues at hand, but they needed to have already aggressively addressed those issues with hefty "haircuts", new equity capital injections and substantial reserve builds. Others we purchased had no material credit rift whatsoever and were just thrown out with the bathwater.

Two, we required that they have excess liquidity to survive the "bear raid" risk from short sellers, CDS cowboys and the now reactive rating agencies (a day late and several dollars short). These investments could not have short term debt in excess of short term cash and near cash assets or *de rigueur* a strong "quick ratio" for *old schoolers* (like us). They had to be fundamentally bullet-proof against the most egregious non fundamental attack on the US financial system ever devised by accountants, lawmakers and speculators *en mass*. **We are at war with 99% of all hedge funds!** We had to adapt to their game and best it. The opportunity set was too great not to. The excessive level of short interest was fuel. The valuations were as we stated in July – "Buy-in of a Lifetime".

Three, they had to have a clear path back to strong profitability and future growth. And fourth, who benefits from the shake-up? Timely investments in Wells Fargo, JP Morgan and numerous small regional banks come to mind. As of now, the Fund has completed a major move into undervalued small cap banks aggressively over the past two months.

In reference to the third requirement, it is of note that we suspect many investors don't understand bank accounting thoroughly. Curiously, business schools teach *widget maker* or manufacturing firm accounting and not financial firm accounting in their case studies. Given that much of America is driven by services, especially financial services and no longer manufacturing, we have no idea why the B-schools are so far behind the times. This is good for us we suspect.

It is of fact that 93% of federally insured bank profits in the second quarter were masked by loan loss provisions. A loan loss provision is a non cash accounting entry that merely moves what otherwise would be retained earnings on the balance sheet over into a contra asset account. Provisions are not to be ignored by any stretch, but they are not a representation of earnings power of a bank or finance company as they, in essence, merely restate prior periods of over statement of earnings power. We realize this concept is difficult for many to swallow. However, when the provisions are spiking, one must begin to discount their impact on future earnings. The provision is less of an earnings issue than it is a capital adequacy issue. For example, a bank that we deemed to be taking aggressive action to resolve current credit losses by adequately retaining or acquiring strong primary capital has a clear path to a quick recovery in profitability and growth again. Capital One Financial, which the Fund loaded long in the $30's in June and July is an example. Cap One is a common short seller target. Historically, Capital One is a *widow maker* for shorts because those shorts constantly under estimate the snap-back earnings power of the company. Its shares have risen as much as 50% since the summer panic. We paid 50% of book value for Cap One and less than 5x earnings power. The Fund recently unloaded some near $60 when it was added to the no short list and we would like another shot at her lower.

In general, we like what we are seeing in credit and banking. Early-stage delinquencies are declining; credit migration is improving; foreclosed asset sales are accelerating; provisioning has been aggressive; and liquidity has greatly improved in the sector through de-leveraging. All that really remains for the majority of financial firm investments is solving the MTM/"bear raid" trade. We have hedged the "bear raid" trade fundamentally through our four-pronged acid test described earlier. Now, we are on to psychology and that's where we believe the Plan at the margin helps.

When the dust settles, we doubt many financial firms will take the government up on their not so little distressed asset hedge fund ambitions. All this wrangling in Washington over minutia in the Plan to become a Bill is far less necessary than believed, acted out and grandstanded over. So, do not be surprised if only the few remaining very troubled institutions are likely to participate and they are not important to us anyway. Your Fund is chock full of well capitalized, highly liquid and quick to recover profitability financials. None of them should have the need nor the desire to sell assets to Uncle Sam based upon our careful assessment. None of your holdings have an interest in giving away stock warrants to the vulture firm of Dodd, Pelosi and Frank LLC. Or become a conservatorship…whatever that is. The Plan will get done. The Bill will become law. And it incrementally gets us closer to an end of all of this because it creates a market maker. How much actually trades there is less important.

Many fund managers have aggressively been betting against America the past few years and with some success. However, "shorting" America is a losing strategy over time and the level of short interest still gambling on the country's demise is living on borrowed accounting. If one can dodge the "bear raid" trade and take advantage of the insane discounts, the opportunities have never been better.

Regards,

Michael P. Durante
Managing Partner