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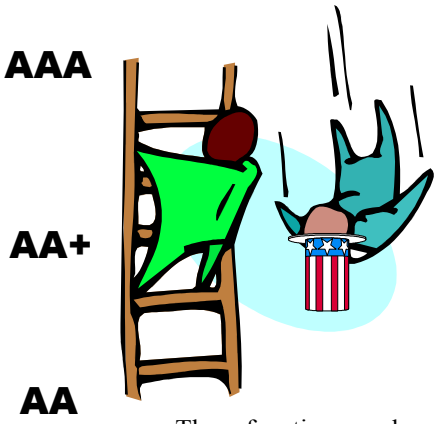
Rating the Raters

The Department of the Treasury was irate when Standard & Poors downgraded U.S. government debt from the top AAA rating to AA+. Their action humiliated Secretary Geithner who had insisted that it wouldn't happen, embarrassed our country whose credit quality now ranks behind that of 17 others (including Guernsey, for heaven's sake), and jeopardized the global appetite for U.S. Federal debt.

Investors ignored the measure and flocked to Treasury bonds. In an article "Just the Facts: S&P's $2 Trillion Mistake," published on the Treasury site on August 6, John Bellows offered the Department's rebuttal. He writes that the decision "was based on a $2 trillion mistake. After Treasury pointed out this error – a basic math error of significant consequence – S&P still chose to proceed with their flawed judgment by simply changing their principal rationale for their credit decision from an economic one to a political one." (The S&P made much of the governmental instability demonstrated by the efforts to raise the debt ceiling.)



The function, role, and guidelines of Credit Rating Agencies ("CRAs") have evolved over time, as has the relationship between CRAs and the government. Ironically, our government in large part created the institution that so infuriated them recently. Given the CRA's power to disrupt markets, we should understand better how credit rating agencies work, or don't.

Poor's Manual of bond analysis was first published in 1890. In 1909 John Moody published Analysis of Railroad Investments, a system for rating bonds. Like today's CRAs, these publications aimed to guide investors' assessment of bond default risk. However, there are two critical differences. Competition among rating agencies was greater in the earlier period, allowing for more divergent ratings. Also, revenue came from investor subscriptions, not from bond issuers paying CRAs to evaluate their bonds as happens today. Thus there was less potential for conflict of interest. The CRA industry stagnated after the 1929 crash and was resurrected in the 1970s when our federal government wanted a standard of credit worthiness to be used to enforce their net capital rule. In 1975, the SEC created the Nationally Recognized Statistical Rating Organization designation (NRSRO) which they conferred on credit rating organizations. Over time, the use of NRSRO ratings became codified in federal regulations and in federal and state statutes. In essence, the U.S. government created a franchise, really an oligopoly with little competition, and no formal policy of how accreditation would be granted.

In this new era, investor subscriptions no longer provided the revenues for the largest CRAs. Rather, bond issuers paid the leading CRAs to provide a rating. Sometimes individual analysts would participate in both the rating

Rating cont'd. p.2

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Rating the Raters, continued

decision and the contract negotiation, or consult with the bond issuer prior to the rating decision, offering an obvious potential for conflict of interest.

The barriers to achieving the NRSRO, a quasi-regulatory license, have been high. S&P, Moody's Corporation and Fitch Ratings dominate the pack which includes only 10 players. The narrow industry range of only three highly visible agencies leads to an equally narrow range of ratings. In Fitch's 8/16 affirmation of US federal debt's AAA rating (noting that "key pillars of US's exceptional creditworthiness remains intact; its pivotal role in the global financial system and the flexible, diversified and wealthy economy that provides its revenue base") they indirectly explained why they didn't follow S&P's lead.

Although the CRAs were designated by the SEC, and the use of their ratings was mandated by governmental regulation, there was limited oversight. CRAs did not have to disclose their surveillance methods or the details of their analysis. Their ratings and comments are "published opinions" and therefore protected by first amendment rights, so inaccurate ratings never cost them. CRAs lacked both transparency and accountability, and they had a captive market. An attendant issue is that investors came to rely on the ratings, neglecting their own due diligence.

This formula invited failure and there were some notable ones. Enron and Worldcom held respectable credit ratings until days before filing Chapter 11 (December 2011 and July 2002 respectively) even though several irregularities already had surfaced. Enron Chair Ken Lay asked Commerce Secretary Don Evans to intercede with Moody's to not assign a below-investment-grade rating in late October of 2011. To his credit, Evans declined, yet it's interesting that Lay considered his intervention a possibility.

Particularly concerned about the SEC's weak oversight of the CSAs, Congress passed the Credit Rating Agency Reform Act of 2006. It required the SEC to set qualifications for NRSRO accreditation and gave the SEC authority to regulate CRA internal processes of record-keeping. The bill was mute on methods of analysis and decision-making criteria used by CRAs.

The mortgage crisis exposed further weaknesses. In 2006 and 2007, ratings upon which buyers of Collateralized Debt Obligations and other structured products relied upon, ended up being generally incorrect at least 90% of the time. The CRAs lacked the ability to rate structured products, particularly those based upon flawed or fraudulent underwriting, and were overwhelmed by the volume of products.

The call for CRA reform has intensified since that debacle. Some reforms showed up in the Dodd-Frank Act and we can expect more rules to come. These are aimed at tightening oversight, increasing transparency, expanding accountability for published ratings and reducing investors' reliance on CRA ratings. In an odd way, things have come full circle from 1975 when the SEC effectively created the monster that elicited Treasury's rage on August 5.

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Economic and Financial Review

"Bad with a chance of worse" sums up the current scene. The dialogue among experts revolves around the odds of recession. Analysts who put lower odds on recession (currently regarded as the "best-case scenario") feel that the U.S. economy will continue to move ahead with slow growth for an extended period.

The U.S. stock market fell by –13.9% in the third quarter, the worst quarterly return since Q4, 2008, while the EAFE Index of large international stocks fell by –19.0%. Growth in the U.S. economy has slowed. Employment and housing have improved, yet progress has been very slight. Consumer spending persists but has been restrained. Despite impressive profits, corporations are not inclined to expand their business or labor force. Households and companies have been reluctant to spend because of an exceptionally uncertain outlook. The logjam in Washington as leaders sought to raise the debt ceiling alarmed investors as it raised doubts that our government would be able to function to improve the economy. In August, in large part in response to the political impasse, S&P did the "unthinkable" and downgraded U.S. Treasury debt. The downgrade presented no clear and present danger yet in the context of European financial problems, it was alarming. Americans worried then and continue to be concerned about contagion from a European banking failure resulting from defaults of sovereign debt of Greece and other foundering economies.

Since the downgrade, investors have flocked to Treasuries as a safe haven, despite unusually low rates. Policymakers have announced their intention to keep rates down, first with Federal Reserve Chairman Bernanke's statement that this was his intention out to 2013, and next with "Operation Twist" in which the Fed plans to purchase longer bonds and to sell a corresponding amount of shorter debt. What may benefit homebuyers and lenders creates a tough environment for fixed income investors. There is little incentive to purchase longer term securities, except for the most bearish investor.

In additional to practical reasons for investor apprehension, there also was the broad propensity to believe bad news, to act on it and therefore make it a self-fulfilling prophecy. Despite attractive valuations in many stocks, this has been a headline-driven market. Stock market returns were not simply negative overall, they were extreme in daily volatility in both directions. In many cases, strong investor reactions to news triggered late-day automatic trading, simply amplifying the trend. We have seen several single day returns of 400-600 on the Dow Jones Industrial Average, with unusually wide intraday ranges.

What could make things worse? Political stalemate in Europe or the US, country level debt default, a proliferation of negative economic indicators, or worse. What could help? A Eurozone solution to sovereign debt threats, a level of accord among our own governmental leaders, a mood change, or a national resolve to move stoically and steadfastly through some difficult years.

The View From Here

Déjà vu all over again. It was August 18 and the market was about to close with a session loss exceeding -400 points on the Dow. Some context: The Dow slid for 8 consecutive losing days before rising 30 points on August 3, then fell by -513 points on August 4, lost -634 points on the 8th, gained 430 points on the 9th, dropped -520 on the 10th and rose +423 on the 11th. Wow! It was the wildest week on Wall Street since the fall of 2008.

With responsibility for client portfolios as well as client psyches, we watch the markets closely. CNBC is on in our office all day long. We not only observe the daily closing price, we watch each agonizing move until the bell sounds and the corporate group of the day performs the applause ritual, clapping madly with inane grins, no matter what the daily results.

When we mentioned our line of work to anyone that week, they flinched sympathetically. Our in-baskets bulged with advice from financial advisor publications, suggesting how we should feel, what we should do, and how we might communicate with those who have trusted us with their assets. The pressure was on! How did we respond?

We have promised our clients: "we will do your worrying for you." However, apart from our concern for our clients' psyches, we tried to <u>not</u> worry. Rather, we went right back to basics and reviewed our philosophy, our strategies, and client portfolios. Studying portfolios reminded us that each client's asset allocation is postured to withstand an individually tolerable amount of loss. We talked through many possible scenarios and considered if we would do anything differently. Most important, we communicated with our clients. Wayne was on vacation with his family in northern Maine that wild week. He came back to the office for 2 days to be available to clients, just in case they called.

For us as advisors, times like these are not pleasant, but they're certainly bearable. These are the moments when we do our most important work. We understand that inevitably, these times will come.

The Acronymic Generation Y

Do you know any KIPPERS? (Kids in Parents' Pockets Eroding Retirement Savings) How about YUCKIES? (Young Unwittingly Costly Kids) or NEETS? (Not in Education, Employment or Training). These acronyms exist because today, nearly 55% (varies with each study) of adult children between 18 and 24 live with parents.* Harper's August issue estimated that 85% of 2011 college grads planned to move home for a while. Many parents continue to financially support adult children, sometimes remortgaging their homes or dipping into retirement savings. Plans for an empty nest, or for maximizing savings in the last 10 years of earning are just not working out.

We both were raised with the expectation of being self-reliant after education. Also, we have a professional concern that parents approaching retirement amass a sufficient nest egg. Given those perspectives, it was easy for us to view this pattern as a negative cultural phenomenon, fostered by "helicopter parents" who hover, and their immature progeny who "fail to launch." Like every one of our readers, we know KIPPERS, YUCKIES and even NEETS. The contrast between them and Wayne's grandfather, for example, who left home in his midteens and crossed an ocean to make his own way in the world is remarkable.

Upon examination, it seems that the trend may be rooted far more in economic than cultural shifts. Simply put: these children cannot afford to live anywhere close to their expectations without significant help from parents. True, their expectations may be on the high side. However, certain economic realties have converged to make financial independence extremely difficult.

For purposes of discussion, we'll ignore NEETS who make no efforts towards independence. KIPPERS live at home while going to school and/or working, hoping to improve their ability to achieve self-reliance. Free from significant housing costs and, perhaps, the distractions of maintaining an abode, they are able to save for a downpayment or improve their employment outlook. In some cases, part of the reason that they allow their parents to offer them shelter and money may be that life is familiar and comfy at home. In addition to the freedom from large household expenses, there's also Mom's cooking and housekeeping efforts. YUCKIES may live apart from parents but receive significant parental contribution towards lifestyle expenses.

Several economic realities united to retard these childrens' financial independence. Wages, including salaries for those newly out of college, have been declining overall. While certain costs also have declined, the cost of living has been rising in the big-ticket areas: housing, education and healthcare. Expenses for personal technology didn't even exist 25 years ago. Between 1980 and 2006, the median price on an existing home (in real dollars) rose 40%. The steep drop in house prices since the fall of 2008 did not offset that entire climb. Mortgages are hard to get without excellent credit ratings and at the very least 10% to put down. Meanwhile, apartment rental costs have been going up. So, meeting housing costs is beyond the reach of many young people. On top of that, approximately two-third of college students have debt, averaging $23,000.

The unemployment rate nationally is over 9%. For those graduating from college in 2010, only 56% had held at least one job by the spring of 2011. Many new graduates are unemployed or underemployed.

With no job, or a low-paying job, and a high debt burden, many young people are not able to meet current costs of living. Perhaps by living with 4 others it would be possible, but that's very undesirable when Mom and Dad have rolled out the welcome mat or opened the wallets.

The real bind is that in many cases, these adult children may never catch up to their lifestyle expectations. Moreover, parents who have partially depleted their retirement nest eggs may well need the kids to reciprocate in a few years.

*S. McGee, Full Nest Syndrome, Financial Planning,Sept 2011,C. Rampell "Many with New College Degrees…" New York Times, 5-18-11. "College Grads with Record Debt Levels," www.asaneapproach.com, 11-30-10, V. Wong, "Are Americans as Poor as They Feel," www.finance. yahoo.com, E. Jensen, "Forget Empty Nesters," www:smh.com, 7-25-08, "NEETS, Yuckies, & KIPPERS," www.dinarickman.wordpress.com, 2/25/10, "Boomerang Generation," www.AdamGoldfein.com, 8-14-11.

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