



NCM Client Notification

SEPTEMBER 18, 2008

A publication of Northern Capital Management, Inc.

Capitulation

To be sure, this has been a trying month if not a trying year. The turmoil in the credit markets is reminiscent of the savings and loan crisis in 1990.

See our article on the next page regarding the AIG takeover to gain a better understanding of the Fed actions.

This communication is being written to address the current market situation.

Presently, nearly every category of stock is being sold off without regard to merit. Even though profit releases from the second quarter and expected profits for the third quarter look reasonable, companies are being dumped.

This type of indiscriminate selling is symptomatic of panic selling. It may now reach a crescendo which for many investors is nearly or is unbearable. A total of \$11 billion was jerked out of stock mutual funds on Monday alone.

We hear a lot of terms and phrases from clients relating to “losing money”. It is extremely important to understand we do not lose money unless we liquidate stock positions.

There are very real human emotions at play....fear and greed. Presently fear is in control.

At this point, markets have reached a level so low we think it likely we are in the final hours of the decline.

Having said that, there is always the chance we will experience a lower low. But if we were to guess, this moment represents another tremendous buying opportunity.

Washington Mutual Bank is being shopped. The only two remaining investment banks, JP Morgan and Morgan Stanley, are contemplating mergers with traditional banks....which would be a good thing.

So, we counsel clients to not buy into the panic. Generally moments like this are the best time to invest and the worst time to sell.

If clients wish to become more aggressive or invest cash, we strongly encourage you to contact us as we believe this represents a tremendous long-term investment opportunity.

Sincerely,

Northern Capital Management, Inc.

Investment Committee

P.S. Tack this to your fridge and check back in 24 months to see if our prognostication was correct.

AIG

With the virtual acquisition of AIG by the Fed, we have once again entered uncharted waters. Actually it is an \$85 billion loan at around 11%. The idea of the loan is it will buy the Fed-company ample time to sell AIG off in pieces at reasonable prices. The term of the loan is a balloon payment. It can exist for up to two years.

Why would the Fed make such a huge capital injection into an entity it does not regulate? In fact, why would the Fed make such a huge capital injection when 79% of AIG's business is conducted overseas and not in the US? Finally, why would the Fed make such a huge capital injection when all of the primary insurance companies they own are regulated and have ample reserves that cannot be raided by the parent company?

The answer to all of these questions resides in a three letter acronym...CDS (credit default swap). A credit default swap is basically an unregulated insurance policy. The policy or contract indemnifies an entity from loss if a loan goes bad.

How are they used? Assume an investor buys \$1,000,000 of GM bonds paying 9% (because they are low-rated). The investor does not want to potentially lose all of their money, so they approach an AIG subsidiary company that sells swaps. For a premium payment of \$30,000 annually the subsidiary will guarantee the GM bonds against default. The investor likes this because AIG is highly rated, stable and he/she will still net 6% (\$90,000 of annual bond interest payments minus the \$30,000 premium) on the investment, which is well above market. Since AIG is highly rated the transaction creates a 6% HIGH quality bond.

So far so good. If the bond issue goes bad (called a credit event) the investor simply delivers the bonds to the AIG subsidiary and they pay him/her the full \$1,000,000 value.

The problem: The major problem is unlike virtually every other type of insurance; the credit default swap market is unregulated. This means there are no reserve requirements (money to back up the swap contract) for the AIG subsidiary. In fact, virtually anybody can write the contracts..... and it gets worse.

Because there is no regulation and because now we have a financial instrument which can be traded between investors, there is no limit to how many guarantees can be issued by multiple parties. In other words, a company may sell \$6 billion worth of bonds to raise capital for expansion, but there could be \$60 billion dollars or more of credit default swap contracts created relative to this bond issue. Basically you have the AIG's of the world betting the bond issue will not fail – meaning they sit back and collect premiums – while somebody else is betting the bond issue will fail (even though they don't own the bonds). This creates a dangerously leveraged situation when traditionally conservative financial institutions begin to invest in or rely on this insurance.

To illustrate how this all works, use our \$1,000,000 bond issue example from above, but pretend the investor doesn't own the bonds and instead buys CDS for \$100,000 on the unregulated open market from perhaps somebody who did own the bonds but is tired of paying the premium.

The investor is betting the bond issue is going to default. They pay \$30,000 per year for a couple of years and BAM!, the issue fails. They collect the full \$1,000,000 on the insurance contract and it only cost them \$160,000 (original contract cost of \$100,000 and two year's premiums totaling \$60,000).

So therein lies the problem. It is further exacerbated if the CDS is purchased.....gulp....on credit. In such a case another party is put at risk.

The Fed was worried about two things:

First, AIG wrote a huge number of CDS – which would be worthless if they went bankrupt. In such a case other institutions who purchased bonds and CDS contracts issued by AIG would be forced to write down the value of their holdings.....thus broadening the crisis.

Second, money markets and other funds that own the bonds of AIG would be forced to write those holdings down as well...which again would not be good.

Hence, intervention.

Our best guess is the Fed will evaluate each corporate situation individually based upon its own merits. This is clearly uncharted territory for the Fed, but not illogical.

Our bottom line...it made sense.