Philequity Corner (October 20, 2008)
By Valentino Sy

Cash and Courage

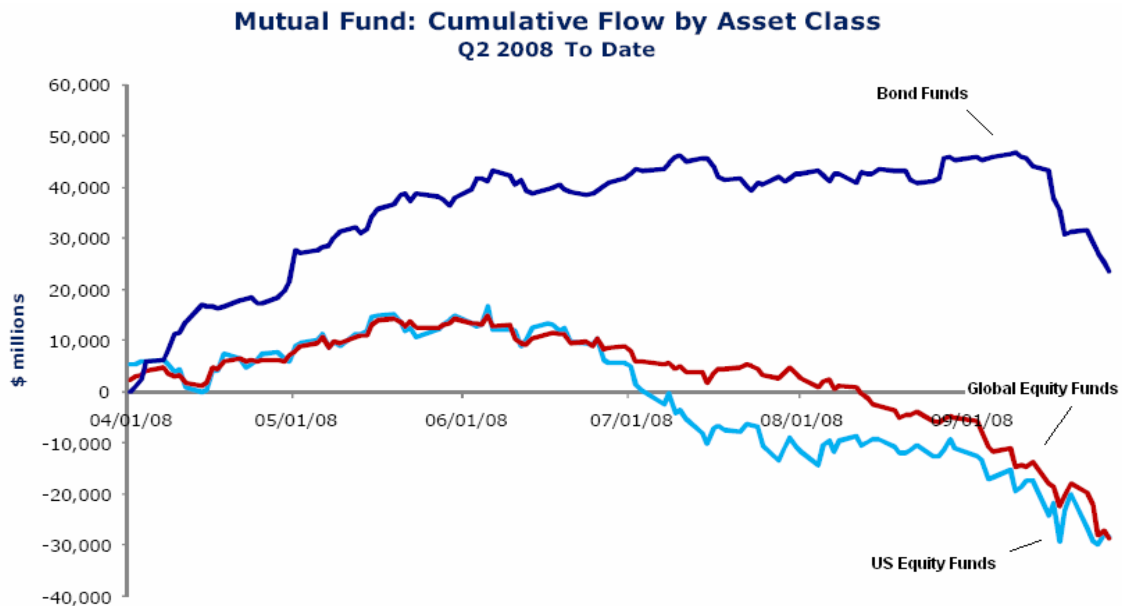
People nowadays prefer to have cash, not only as part of their regular asset allocation, but because the traditional safety of bonds and derivatives used to hedge against volatility have now been put to question (see last week's article *Nowhere to Hide*). Even consumer staples and other defensive sectors which provide protection in a falling market were not spared in the onslaught experienced over the past several weeks.

In these times of extreme volatility, one realizes the importance of having cash and not being leveraged. In fact, among investors and fund managers, the topic of conversation now is the percentage of cash one holds in their portfolio. It has become a bragging right now to have cash. It seems that the bigger, the better.

De-leveraging

One of the primary reasons why asset prices have fallen violently is due to de-leveraging. While central banks injected $3 trillion into the global economy, credit markets are still frozen because banks are curbing lending, forcing investors who borrowed money to unload assets even at extremely low prices. The collapse of Lehman Brothers triggered even more selling as investors were concerned that more banks will fail. This was further compounded by hedge funds and mutual funds dumping holdings to meet redemptions.

Outflows from equity funds and bond funds are on track to set all-time highs in October, according to TrimTabs Investment Research, which has been tracking the data since 2000. Both funds have experienced the most ferocious selling, losing an estimated $35.3 billion for October 1 – 15 alone.



Source: TrimTabs Investment Research

Meanwhile, TrimTabs says that outflows from hedge funds amounted to $43 billion in September, marking only the beginning of what they expect to be a series of outflows for the remainder of the year. What's worse is that most of these hedge funds are leveraged 3-to-1 or even 5-to-1 which means that the outflows would lead to asset sales three times or even five times as much.

The Anointed Nine

As discussed in last week's article, global central banks are now pulling all stops to address this global financial crisis in a coordinated manner. European governments have already disclosed plans to invest more than $2.5 trillion into the European financial system, while the US Congress has already approved the $700 billion rescue plan.

Recently, the US Treasury decided to appropriate a third of that $700 billion to recapitalize US banks. The government will invest $125 billion in nine major banks (see table below). The other $125 billion will be spread among smaller banks nationwide. The terms of the investment include buying non-voting, preferred shares plus warrants worth 15 percent of the face value of the preferred shares.

Beneficiary Banks

Citigroup	$25bn	Goldman Sachs	$10bn
JP Morgan	$25bn	Morgan Stanley	$10bn
Wells Fargo	$25bn	State Street Bank	$2bn-3bn
Bank of America	$12.5bn	Bank of New York	$2bn-3bn
Merrill Lynch	$12.5bn		

Source: US Treasury

To encourage inter-bank lending, the FDIC will now guarantee 100 percent of banks' senior unsecured debt. It will also guarantee all deposits held in non-interest-bearing transaction accounts until the end of 2009. This should bring back confidence in banks and prevent a run on deposits.

Wave after wave

The old saying that when the US sneezes the rest of the world catches a cold still holds. What started out as sub-prime and credit crises in the US has now spread worldwide as wave after wave the problems gets bigger (see table below).

Even commodity-driven economies (such as Russia and Brazil), previously unscathed by the sub-prime/credit crisis are now feeling the pain as commodity prices plunged. Meanwhile, the crisis has now spread to far-flung countries such as Iceland (located in Northern Europe), Dubai (in the Middle East) and South Korea (which is much closer to home).

Sub-prime/Credit Crises Timeline

2007	
Feb-Mar	Subprime industry collapsed; more than 25 lenders declaring bankruptcy.
Jun	Bear Stearns two funds closed down due to redemptions
Aug	BNP Paribas closed three of its funds and suspended withdrawals Countrywide Financials narrowly avoids bankruptcy
Sep	British Bank Northern Rock faced liquidity problems
Oct	US banks announces billion dollar losses from subprime crisis
2008	
Mar	Bear Stearns gets acquired by JP Morgan
Jul	IndyMac placed under receivership
Sep	Federal takeover of Fannie and Freddie Merrill Lynch sold to Bank of America Lehman files for bankruptcy AIG bailed out by US Fed Washington Mutual seized by FDIC, assets sold to JP Morgan
Oct	US Congress passes $700 billion rescue plan Financial crisis spreads to Europe UK nationalizes its three biggest banks Several European countries guarantees interbank lending & deposit insurance Coordinated rate cuts by global central banks led by Fed and ECB G7 agrees to address global financial crisis in a coordinated manner US announced injection of $250bn into US banks

Source: Wikipedia

Cash + Courage = Priceless

We, in Philequity, agree that the process of de-leveraging is not yet over and that big rebound we saw last week was the result of the oversold market. We also agree that we will have a deep economic downturn. However, what the central banks are doing will be the antidotes to stop the economy from going into depression.

With fear and panic gripping the markets, those holding cash will be able to cherry-pick the bargains. In contrast, those without cash will have to sit on the sidelines and watch this once-in-a-lifetime opportunity go by.

There are a lot of opportunities in a market turning around even if the risks are also high. This brings to mind what Warren Buffett said "***Cash combined with courage in a crisis is priceless***."

Last Friday, Buffett told New York Times that he is now buying US stocks for his personal account.

For comments and inquiries, you can email us at info@philequity.net. You can also view our archived articles at www.philequity.net or www.yehey.com/finance.