Allaying Investors' Worst Fears

Washington's Latest Measures to Ease the Financial Crisis Won't Prevent A Recession, But They Should Forestall Something Worse.

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Contents

Executive Summary	1
Overview	2
Thawing Frozen Credit Markets	2
Sifting for Equity Opportunities	4
Maintaining Perspective	5
About the Authors	5

Authored by:

Colin Moore
Managing Director and Chief Investment Officer

Robert McConnaughey
Managing Director, Head of Equity

Executive Summary

- **Last week's plunge in equity prices was rooted in fear that the financial crisis would usher an economic collapse reminiscent of the Great Depression.**

  Despite unprecedented moves by governments worldwide to backstop the financial markets, investors remained fearful that the public sector would be unable to prevent the credit crisis from morphing into an economic crisis.

- **The plan to invest public funds directly in U.S. banks should alleviate the systemic risk in the financial system.**

  We believe the Treasury's decision to purchase senior preferred shares in U.S. banks is sound in that it addresses the problem at the core of the financial crisis, namely anemic capital levels. In doing so, it alleviates concerns that the health of the nation's financial institutions will deteriorate further. That said, investors are still expecting a long and difficult convalescence for the financial sector.

- **The Treasury's recent measures will not prevent a painful recession, but they should forestall the economic collapse investors feared.**

  The latest measures to address the credit crisis will not likely prevent a painful and perhaps prolonged economic downturn, which currently is discounted into equity prices. They will, however, give banks a more stable environment in which to continue the deleveraging process that is essential to restoring the health of the financial sector.

- **While attention is currently focused on the plan to purchase bank shares, the value of earlier interventions should not be discounted by investors.**

  We are sanguine about the impact of the equity infusion on the health of the credit markets, but we believe prior measures to relieve banks of their distressed mortgage-related securities and to purchase their commercial paper will likely play equally important roles in restoring the flow of credit.

- **The sell-off in the equity markets has created select opportunities for investors.**

  Valuations have fallen to the point where investors with long investment horizons and strong risk tolerances may want to begin shopping, particularly for companies with strong balance sheets. Given the shortage and high cost of credit, businesses with strong capital and customer bases have a distinct advantage over their more poorly positioned competitors.

Overview

As the credit crisis intensified in September, bond spreads and other fixed-income metrics were signaling the onset of nothing less than a full-on depression. By comparison, the stock market was the picture of composure, portending a garden-variety recession rather than the economic apocalypse baked into bond prices.

That all changed last week as the tenuous optimism that had supported equity prices went the way of Bear Stearns and Lehman Brothers. In a matter of days, the Dow Jones Industrial Average plummeted almost 1,900 points. The broader market as measured by the Standard & Poor's 500 Index declined 18 percent. The Chicago Board Options Exchange Volatility Index or VIX, which measures the cost of hedging against declines in the S&P 500, hit above 70; two weeks earlier it was less than 30.

The plunge in equity prices reflected growing anxiety among investors that despite unprecedented moves by governments worldwide to backstop the financial markets, the public sector would be unable to prevent the credit crisis from morphing into an economic crisis. Put simply, investors feared the government was "running out of bullets." As it turned out, the biggest bullet of them all was in the chamber: a $250 billion investment of public funds directly into the nation's banks

Attacking the Problem at Its Source

In our view, the Treasury's decision to purchase senior preferred shares in U.S. banks is a welcome development in that the move addresses the problem at the core of the financial crisis, namely anemic capital levels. As banks wrote down the value of mortgage-backed securities, their capital ratios plummeted. As a result, many banks have been reluctant to fulfill their primary mission—lending money—for fear that losses on new loans would further deplete their capital reserves. An infusion of cash from the Treasury should prompt them to relax their grips on the purse strings, increasing the flow of credit. At the least, it should allow them to accelerate the pace of write-downs, thereby expediting the cleansing of their balance sheets.

As optimistic as we are that the direct investment of government funds into banks will alleviate the credit crisis, we are under no illusions that this latest measure (or the preceding interventions) will, by itself, cure the ills afflicting the financial system. Neither do we believe it will prevent the painful economic downturn the credit crisis almost surely has sired. What it will do, in our view, is buy the nation's financial institutions time to continue the painful deleveraging process that has roiled the bond markets for weeks but, which over time, should help restore the health of the financial system. In so doing, it will likely prevent a global economic collapse, fears of which caused last week's sell-off.

Thawing Frozen Credit Markets

Restoring the flow of credit from Wall Street to Main Street is central to preventing a severe economic dislocation. The U.S. government took a significant step this week to thaw the credit markets by initiating a program to purchase the preferred stock of the nation's banks, a move that would enable banks to improve their capital ratios and potentially increase lending. Washington also announced that the Federal Deposit Insurance Corporation (FDIC) would temporarily guarantee the senior debt of financial institutions insured by the FDIC as well as deposits in the non-interest

Currently banks are reluctant to lend to each other because they have little confidence in the quality of their counterparts' collateral.

bearing accounts that typically house businesses' operating funds. Whether the direct injection of capital into U.S. banks will address the paralysis in the credit markets depends on the banks' willingness to put the government's funds to work. Rather than increase lending, some institutions may continue to hoard their dollars to protect themselves from further asset deterioration. However, the consensus view seems to be that the equity purchase program is superior to the other remedies introduced by Washington because it represents a systemic solution, whereas earlier measures addressed only the symptoms of the crisis.

While we are sanguine about the impact of the equity infusion on the health of the credit markets, we are not discounting the value of earlier interventions, which may prove as instrumental to the future recovery of the financial system as the measures announced this week. A good case in point is the Troubled Asset Recovery Program or TARP through which the government intends to relieve financial institutions of the distressed mortgage-backed securities contaminating their balance sheets. During the contentious debate on TARP, the measure came to be known as the "$700 billion Wall Street bailout", sloppy shorthand that reflects misunderstandings about both the cause of the credit crisis and the potential impact of TARP.

When asked to explain the credit crisis, we frequently compare the frozen credit markets to traffic gridlock in a major city. In our analogy, the cause of the backup is a violent collision of several cars at a key intersection. The cars involved are totaled and, as a result, suffer a nearly 100 percent loss in value. Unfortunately, the damage isn't limited to those cars. The vehicles immediately behind the wrecks sustain minor damage and may require some minor repairs. Eventually even the unimpaired cars can not perform their function, the result of a tie-up caused by a relatively small number of damaged vehicles.

Eliminating Credit Gridlock

In a very real sense, the purchase of troubled assets by the Treasury amounts to clearing those wrecked vehicles from the intersection. Rather than indemnifying the owners of impaired and virtually worthless securities (as the term "bailout" implies), TARP aims to remove those wrecks from the scene, thereby addressing the paralysis that has reduced the value of even structurally sound assets. Theoretically this should increase asset values and eventually strengthen balance sheets. It should also promote greater transparency, which is essential to the proper functioning of the credit markets. Currently banks are reluctant to lend to each other because they have little confidence in the quality of their counterparts' collateral. As institutions transfer their problematic assets to the Treasury, confidence in the remaining capital should grow, increasing lending activity and ultimately reducing the cost of credit.

Another important component of Washington's effort to contain the collateral damage from the credit crunch is its plan to buy commercial paper—short-term, unsecured debt—relied upon by corporate America to fund everything from inventories to payroll. Commercial paper issuance has declined dramatically in recent weeks, dropping from approximately $1.8 trillion a month ago to $1.6 trillion today. That is a massive withdrawal that primarily affects banks, which account for about 75 percent of commercial paper issuance. Given their reliance on this short-term credit, it is easy to see why some banks have failed.

The Treasury aims to resuscitate commercial paper issuance by effectively becoming a buyer of last resort. The importance of this measure can not be overstated because

it not only allows institutions to meet their needs for short-term liquidity, it makes them more likely to lend to their fellow banks because they know other institutions can place their debt. As confidence in the system begins to grow, banks likely will become comfortable purchasing not only overnight paper, which predominates now, but 30-day and even 90-day securities. As liquidity is freed up down the line, it may encourage investors to buy investment-grade corporate debt. That activity even flows back into the equity market because these asset classes are all linked in terms of their implied risk premiums.

As important as the two measures described above are to the future health of the credit markets, it will not be any one or two interventions that restore the flow of credit. Rather it will be the collective affect of the many steps taken by governments globally to create liquidity. Over time, the hundreds of billions of dollars Washington has invested in the financial system—either directly or indirectly—should begin to thaw the credit markets. All that's required for the government's programs to work, in our view, are time and a little confidence on the part of investors. Unfortunately both are at a premium in the current environment.

Sifting for Equity Opportunities

Many of the commentaries on last week's rout of the equity markets portrayed it as a panic, a capitulation to fear and pessimism. Fear no doubt played part in the violent sell-off, but the carnage in the equity markets also reflected a rational response to changed expectations for corporate earnings. Earlier this year, earnings estimates for the Standard & Poor's 500 were around $100. Fallout from the financial crisis could easily knock that figure down 30 percent. Taking into account the diminished expectations for earnings, the market's 40-percent drop does not appear to be purely the result of panic selling.

The question confronting investors now is whether the diminished expectations for economic growth and corporate earnings are fully discounted into equity prices. We have conducted extensive scenario testing, and we believe that in aggregate, expectations are low enough for long-term investors with cast iron risk tolerances to begin shopping for opportunities. We recommend caution even for these investors, however, because valuations have not plunged to the point that we now have an historic buying opportunity across the board. Rather, we see selected opportunities in sectors that have seen their share prices battered—energy and retailing being good examples. We are looking for companies that have strong customer bases, diversified product lines and, most important, gold-plated balance sheets. In short, we like companies that are positioned not only to weather the current turbulence, but also to grow when the business cycle turns.

While a number of variables determine a given business's prospects, the current environment puts a premium on capital. Given the shortage and high cost of credit, businesses with strong capital have a decisive advantage over those with anemic capital bases because the former can meet their funding needs without dilutive stock issuance. Accordingly, we believe that in the months ahead, a brutal corporate Darwinism will separate those businesses that can control their own destinies from those who must either turn to wounded credit markets for capital or issue stock at what probably will be bargain prices.

Companies that have the cash to invest in their businesses will find extraordinary opportunities and not just with regard to vulture investing. Well-capitalized companies are in an enviable position to expand market share simply because so many of their competitors either have been weakened or taken out of the game altogether by the challenging market environment. This should enable them to achieve not only the aforementioned market share gains, but also improved return on assets.

Maintaining Perspective

Despite a coordinated response to the credit crisis from our government and others around the globe, equity and fixed-income investors have remained skeptical that the public sector can contain the damage from the turbulence in the financial markets. In our view, this is unduly pessimistic.

In the weeks ahead, the U.S. Treasury will begin to inject significant amounts of new capital into the banking system, while also helping institutions shed the troublesome assets that lie at the core of the credit crisis. These measures reflect a shift on the part of governments worldwide from rescuing individual financial institutions to making massive investments in the financial system as a whole. We believe this is a positive development that should inspire confidence on the part of investors, who will hopefully begin to recognize that the public sector has both the expertise and the resources to successfully address the credit crisis. In our view, that realization, combined with the attractive equity valuations the crisis has created, will likely lure investors back to the markets.

In summary, it may take a few months, but investors will likely come to see the current crisis as they have come to view past dislocations: as a source of opportunity for those who kept their heads, while all around them others were losing theirs.

About the Authors

Colin Moore

Managing Director, Chief Investment Officer

Colin Moore is the chief investment officer for Columbia Management. His responsibilities include ensuring that a disciplined investment process is in place across all asset classes, including equity, fixed income and cash. He is also responsible for spearheading the development and implementation of Columbia Management's proprietary alternative investment product offering, a key component of the company's long-term growth strategy. Mr. Moore joined Columbia Management in 2002 as head of equity and has been a member of the investment community since 1983.

Prior to joining Columbia Management, Mr. Moore was chief investment officer of global and international value equities and associate director of research at Putnam Investments. While serving in this role, he personally managed $3 billion in addition to overseeing a team of 29 analysts and five portfolio managers. Previously, Mr. Moore was director of research and chief investment officer for Rockefeller & Co. in New York and London. Throughout his career in the investment industry, he has held

portfolio management positions with three London-based asset management firms, as well as a role in product development.

Mr. Moore attended the London Business School where he completed its Investment Management Program, and he is an associate by examination of the Institute of Investment Management and Research.

Robert McConnaughey, CFA

Managing Director, Head of Equity

Robert McConnaughey is the head of equity for Columbia Management. Mr. McConnaughey joined Columbia Management in 2002 as director of fundamental equity research and has been a member of the investment community since 1993.

Prior to joining Columbia Management, Mr. McConnaughey served as the associate director of research for Citigroup Global Asset Management, overseeing growth industry equity research analysis worldwide. Previously, he was a managing director of Prudential's Real Estate Securities Group, where he directed research and portfolio management of retail and institutional assets. Mr. McConnaughey began his career in investment management at Fidelity Management & Research, where he was an analyst and portfolio manager.

Mr. McConnaughey earned his B.A. degree from Dartmouth College.

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The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

The Chicago Board Options Exchange OEX Volatility (VIX) Index reflects a market estimate of future volatility, based on the weighted average of the implied volatilities of 8 OEX calls & puts – the nearest in & out of the money call & put options from the 1st and 2nd month expirations.

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100 Federal Street, Boston, MA 02110
www.columbiamanagement.com

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