

How To Invest In The Coming Bear Market

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Are We Going To Have A Recession?

“Here’s what’s on its way: ‘recession’ is getting mentioned a lot more in the media these days. Official recessions get declared well after they’ve already begun, as we know, but the acknowledgement is preceded by gradual movement in the public forum from ‘there’s no danger of a recession’ to ‘there’s the possibility of a recession’ to ‘there’s a recession in X region or Y sector’ to ‘we’re in a recession’ to ‘holy crap, will this recession ever end?’ - at which point the recession is already over.”

- Anonymous Hedge Fund Manager

If Not Recession, Then Shmashmession

- “The war situation has developed not necessarily to Japan’s advantage” - Japanese Emperor Hirohito, August 14, 1945

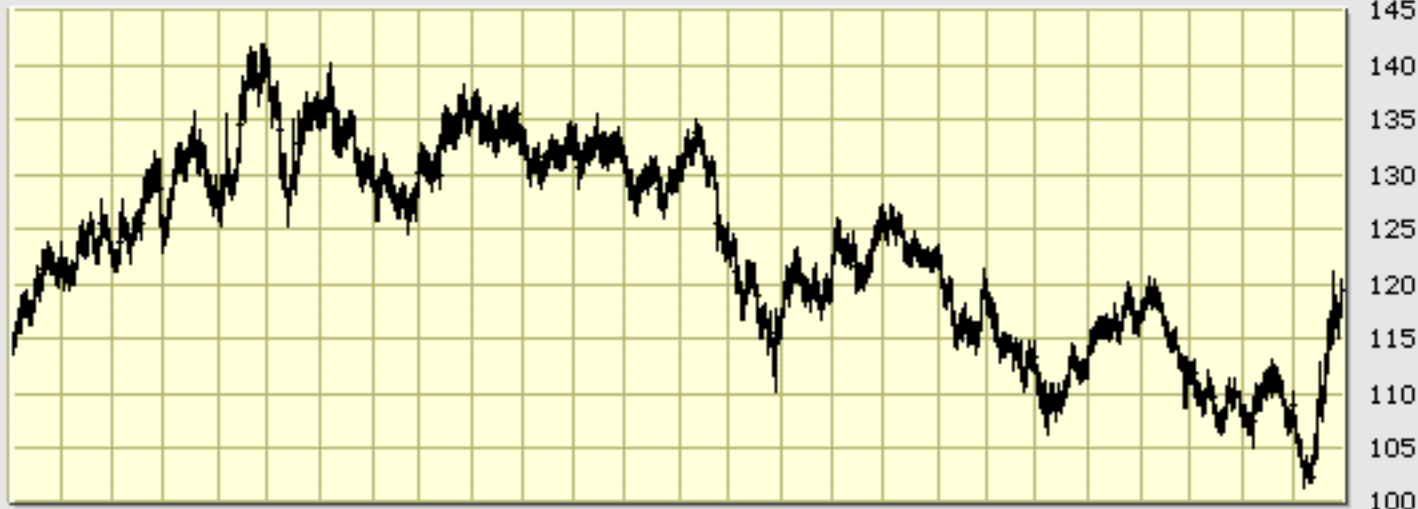
- “The economic situation has become distinctly less favorable since the time of our July report” - Federal Reserve Chairman, Ben Bernanke, testimony to Congress Wed-Thu (Feb 27-8)

- “I don’t think we’re headed to recession, but no question we’re in a slowdown” – President Bush, Press Conference, Thursday February 28

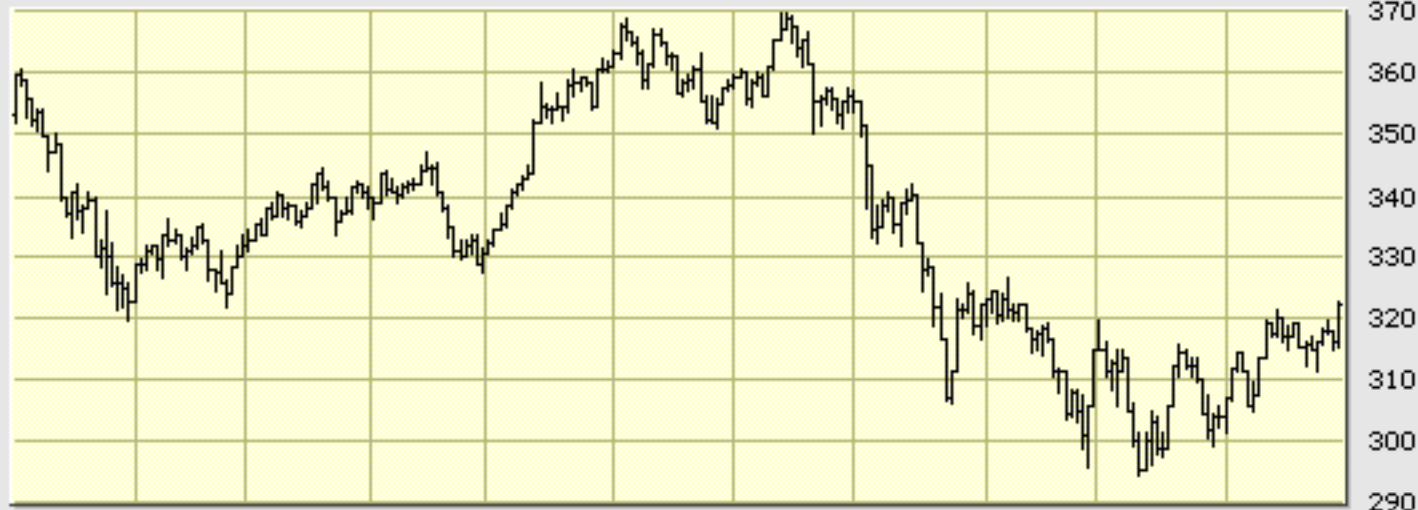
Source: Dan Gross, “The Unspeakable R Word”, Slate, March 1, 2008

The Boom and Bust Cycle

- Throughout the 20th century, economies and stock markets have continuously gone through cycles of boom and bust
- Examples: 1981-82, 1990, 2000-02



Exchange provides
no volume data.



Exchange provides
no volume data.

Feb

Mar

Apr

May

Jun

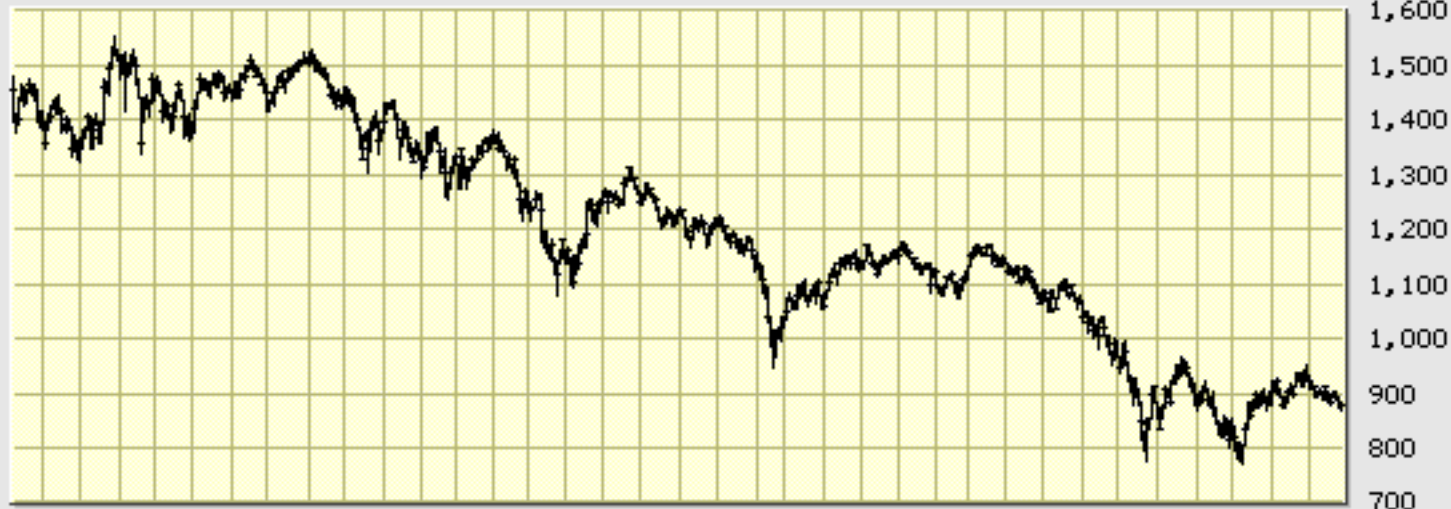
Jul

Aug

Sep

Oct

Nov



Exchange provides
no volume data.

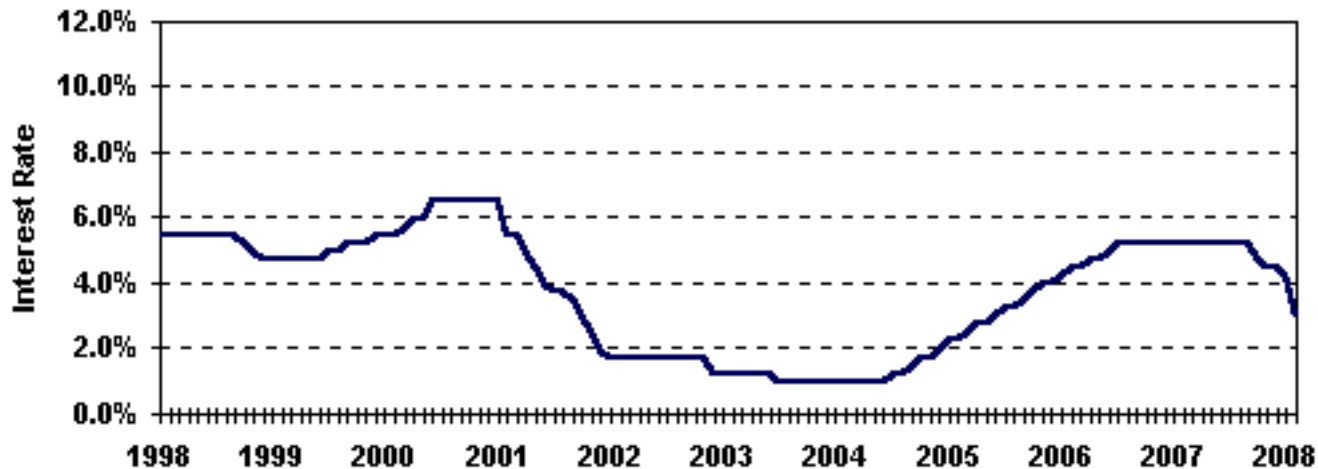
What Is The Cause of the Boom and Bust Cycle?

- The Sunspot Theory (1870s, William Stanley Jevons)
- Inherent To Capitalism (Karl Marx)
- Psychology
- Monetary Policy (Ludwig von Mises, *The Theory Of Money And Credit* (1912))
- Conclusion: Probably a combination of monetary and psychological forces

Greenspan and the Aftermath of the Tech Bubble

- 1% Fed Funds Rate

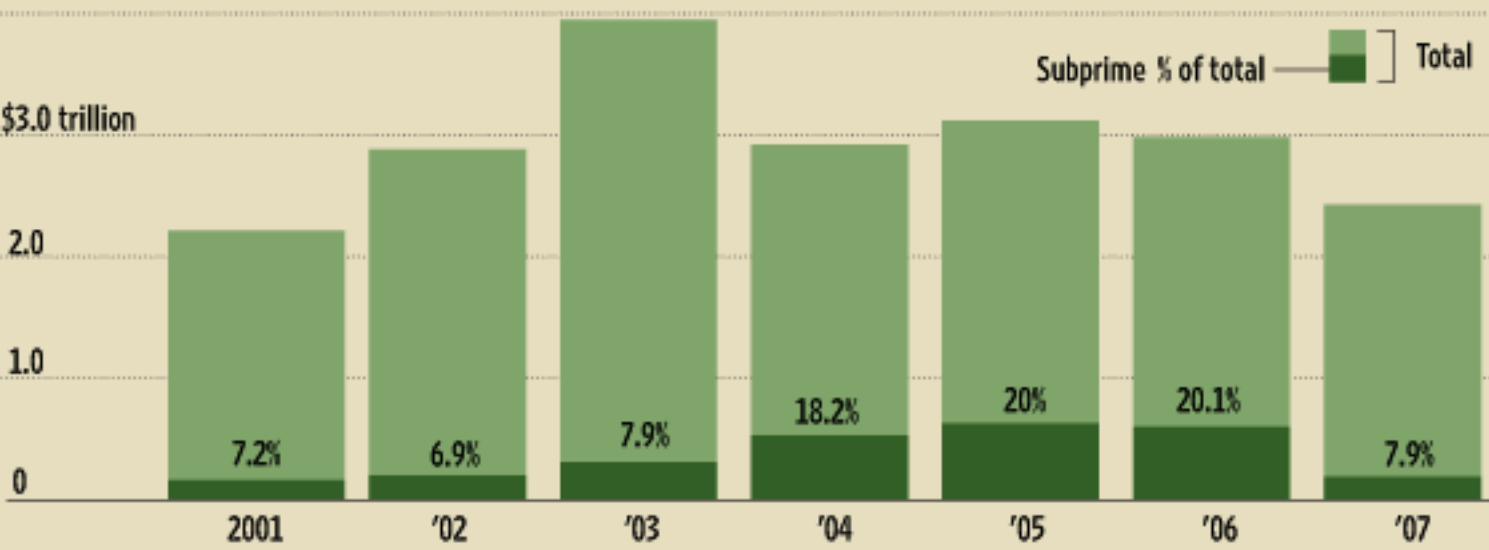
Federal Funds Target Rate



The Housing Bubble

- Artificially low mortgage rates = artificial demand
- Unconventional mortgages: ARMs, Interest Only, Option Adjustable ARMs, Low Documentation
- The Wall Street Mortgage Machine

Subprime-loan originations as a share of total loan originations each year



Follow the Mortgage

What happens to your mortgage after you sign on the dotted line

MORTGAGE-BACKED SECURITY

Borrower



Works with a broker or directly with a lender to get a home-purchase loan or a refinancing

Broker

Finds a lender who can close the loan. They usually have a working arrangement with multiple lenders.



Lender



Often funds loan via 'warehouse' line of credit from investment bank. Then sells loan to investment bank

Investment Bank

Packages the loans into a mortgage-backed bond deal, often known as a securitization.



Sells the securitization sorted by risk to investors. Lower-rated slices take the first defaults when mortgages go bad, but offer higher returns.



Investors

Choose what to buy based on their appetites for risk and reward.



What they get

Financing needed to purchase a home or cash from refinancing

Takes fees for doing the preliminary sales and paperwork

Takes up-front fees for making the loan

Collects fees for packaging the loans into bond deal

Earn interest on the bonds and absorb any gain or loss in price of the bond.

If the loan goes bad

House can be repossessed

May get cut from lender's approved broker list

Can be forced to take back loan if there's an early default or documentation is questionable

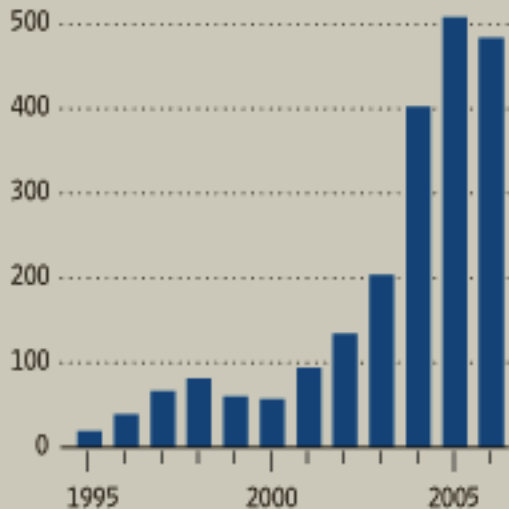
May push back loan to lender, or be forced to eat any loss

May have legal recourse against bank if they can show the quality of the loan or loan documentation was misrepresented.

Through the Roof

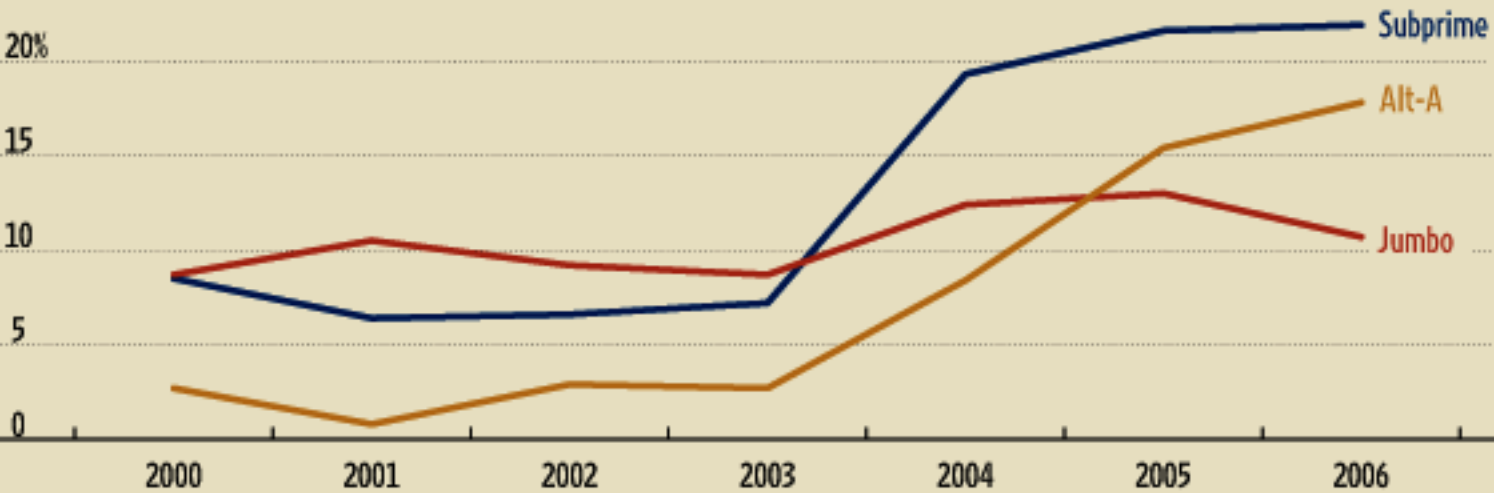
Total industrywide volume for subprime mortgage-backed securities:

\$600 billion



Source: Inside Mortgage Finance

Percent of total mortgage-backed securities market



The Housing Bust

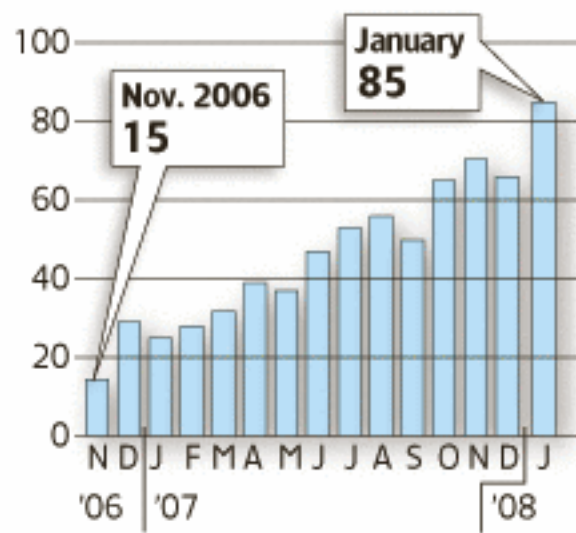
- Median Price Down More Than 30% in Sacramento (\$253,000) and Placer (\$360,500) Counties from August 2005 peak (\$387,000, \$525,000)
- Sales volumes down approx. 30%
- Foreclosures mounting: as many foreclosures (1782) as home sales (1815) in Sacramento area in January '08
- New Century Financial
- Bear Stearns Hedge Funds: High Grade?
- Merrill: \$8 billion 3Q, \$11.5 billion 4Q Writedowns
- Citi: \$18 billion 4Q Quarter Writedown

Foreclosures on the rise

In January, banks repossessed almost 85 homes, on average, every business day in the Sacramento region, according to Foreclosures.com. That's double the rate from eight months ago.

Source: Foreclosures.com

Foreclosures per business day, Sacramento region



Sacramento County has more foreclosures per capita than most of California's other large counties

| County | Jan. 2008 foreclosures | Housing units | Jan. foreclosures per 10,000 housing units |
|-------------------|------------------------|---------------|--|
| RIVERSIDE | 2,535 | 732,433 | 34.6 |
| SAN BERNARDINO | 1,670 | 668,378 | 25 |
| SACRAMENTO | 1,336 | 542,527 | 24.6 |
| CONTRA COSTA | 636 | 389,134 | 16.3 |
| SAN DIEGO | 1,288 | 1,125,820 | 11.4 |
| FRESNO | 341 | 299,578 | 11.4 |
| ORANGE | 781 | 1,023,053 | 7.6 |
| LOS ANGELES | 2,455 | 3,356,418 | 7.3 |
| SANTA CLARA | 266 | 609,787 | 4.4 |

Note: Complete data for Alameda County were not available

Foreclosures.com; U.S. Census Bureau; Bee Research

January home sales

Number sold and median sales price*. Data for closed escrows each month.



EXISTING DETACHED HOMES

| | ESCROWS CLOSED | | | | MEDIAN PRICES | | | |
|------------|----------------|----------|----------|----------------------|---------------|-----------|-----------|----------------------|
| | Jan. '07 | Dec. '07 | Jan. '08 | Change over one year | Jan. '07 | Dec. '07 | Jan. '08 | Change over one year |
| Amador | 27 | 21 | 19 | -29.6% | \$337,000 | \$306,000 | \$251,500 | -25.4% |
| El Dorado | 153 | 147 | 99 | -35.3% | \$438,750 | \$410,000 | \$382,500 | -12.8% |
| Nevada | 88 | 84 | 52 | -40.9% | \$475,000 | \$425,000 | \$401,500 | -15.5% |
| Placer | 306 | 228 | 222 | -27.5% | \$445,000 | \$373,250 | \$350,000 | -21.3% |
| Sacramento | 1,074 | 953 | 910 | -15.3% | \$342,000 | \$274,500 | \$250,000 | -26.9% |
| Yolo | 90 | 90 | 70 | -22.2% | \$379,500 | \$310,000 | \$296,000 | -22.0% |
| Yuba | 44 | 40 | 47 | 6.8% | \$220,000 | \$217,000 | \$215,000 | -2.3% |

EXISTING CONDOS

| | ESCROWS CLOSED | | | | MEDIAN PRICES | | | |
|------------|----------------|----------|----------|----------------------|---------------|-----------|-----------|----------------------|
| | Jan. '07 | Dec. '07 | Jan. '08 | Change over one year | Jan. '07 | Dec. '07 | Jan. '08 | Change over one year |
| Amador | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a |
| El Dorado | 3 | 0 | 0 | n/a | \$340,500 | n/a | n/a | n/a |
| Nevada | 4 | 2 | 3 | -25.0% | \$287,500 | \$203,500 | \$250,000 | -13.0% |
| Placer | 15 | 20 | 14 | -6.7% | \$285,000 | \$292,500 | \$380,000 | 33.3% |
| Sacramento | 32 | 38 | 26 | -18.8% | \$166,500 | \$125,000 | \$102,500 | -38.4% |
| Yolo | 6 | 6 | 4 | -33.3% | \$249,250 | \$251,500 | \$215,000 | -13.7% |
| Yuba | 1 | 0 | 0 | n/a | \$131,000 | n/a | n/a | n/a |

NEW HOMES

| | ESCROWS CLOSED | | | | MEDIAN PRICES | | | |
|------------|----------------|----------|----------|----------------------|---------------|-----------|-----------|----------------------|
| | Jan. '07 | Dec. '07 | Jan. '08 | Change over one year | Jan. '07 | Dec. '07 | Jan. '08 | Change over one year |
| Amador | 9 | 4 | 2 | -77.8% | \$421,750 | \$408,250 | \$836,250 | 98.3% |
| El Dorado | 35 | 18 | 12 | -65.7% | \$497,500 | \$525,000 | \$483,500 | -2.8% |
| Nevada | 15 | 6 | 4 | -73.3% | \$295,000 | \$352,500 | \$627,000 | 112.5% |
| Placer | 191 | 277 | 118 | -38.2% | \$411,000 | \$375,000 | \$379,000 | -7.8% |
| Sacramento | 270 | 381 | 141 | -47.8% | \$376,500 | \$309,250 | \$286,000 | -24.0% |
| Yolo | 67 | 65 | 55 | -17.9% | \$425,000 | \$360,000 | \$345,500 | -18.7% |
| Yuba | 32 | 38 | 17 | -46.9% | \$320,000 | \$281,000 | \$321,000 | 0.3% |

ALL HOMES

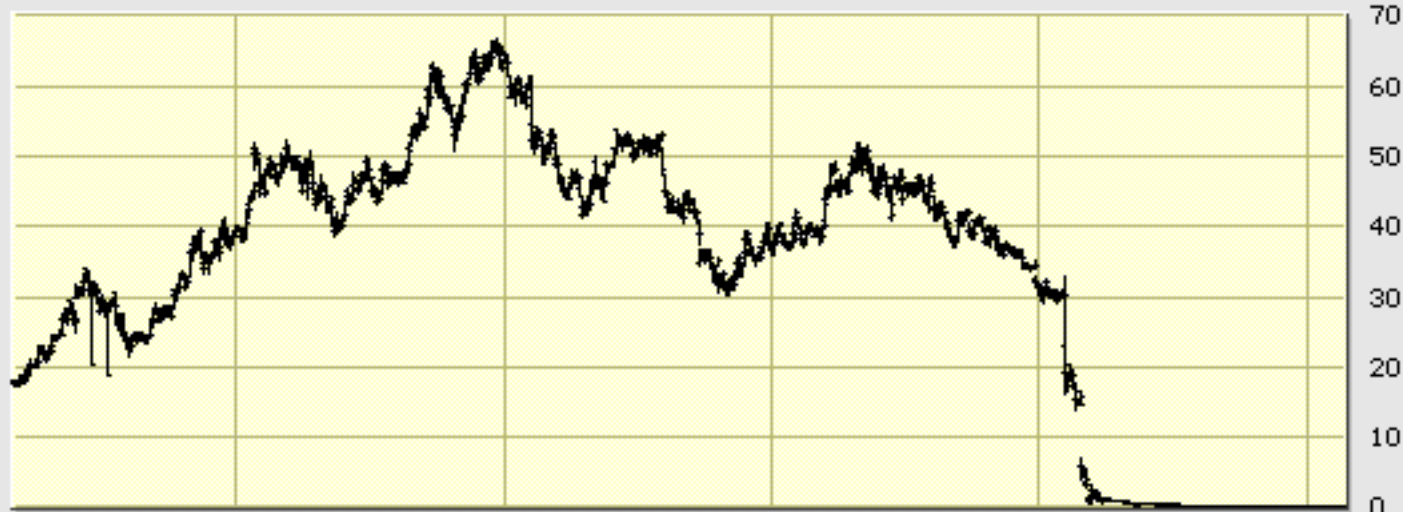
| | ESCROWS CLOSED | | | | MEDIAN PRICES | | | |
|------------|----------------|----------|----------|----------------------|---------------|-----------|-----------|----------------------|
| | Jan. '07 | Dec. '07 | Jan. '08 | Change over one year | Jan. '07 | Dec. '07 | Jan. '08 | Change over one year |
| Amador | 36 | 25 | 21 | -41.7% | \$355,500 | \$331,500 | \$251,500 | -29.3% |
| El Dorado | 191 | 165 | 111 | -41.9% | \$450,000 | \$437,250 | \$407,500 | -9.4% |
| Nevada | 107 | 92 | 59 | -44.9% | \$445,000 | \$415,000 | \$405,000 | -9.0% |
| Placer | 512 | 525 | 354 | -30.9% | \$423,500 | \$373,000 | \$360,500 | -14.9% |
| Sacramento | 1,376 | 1,372 | 1,077 | -21.7% | \$345,500 | \$280,000 | \$253,000 | -26.8% |
| Yolo | 163 | 161 | 129 | -20.9% | \$390,000 | \$330,250 | \$307,500 | -21.2% |
| Yuba | 77 | 78 | 64 | -16.9% | \$281,500 | \$245,000 | \$233,250 | -17.1% |

* Median prices are where half number of homes sell for more and half sell for less. Note: Sutter County data not available. Amador County resales included resale condos (the county does not break them out separately).

Source: DataQuick Information Systems
Bee research by Phillip Reese and Jim Wasserman
Nam Nguyen/nnguyen@sacbee.com

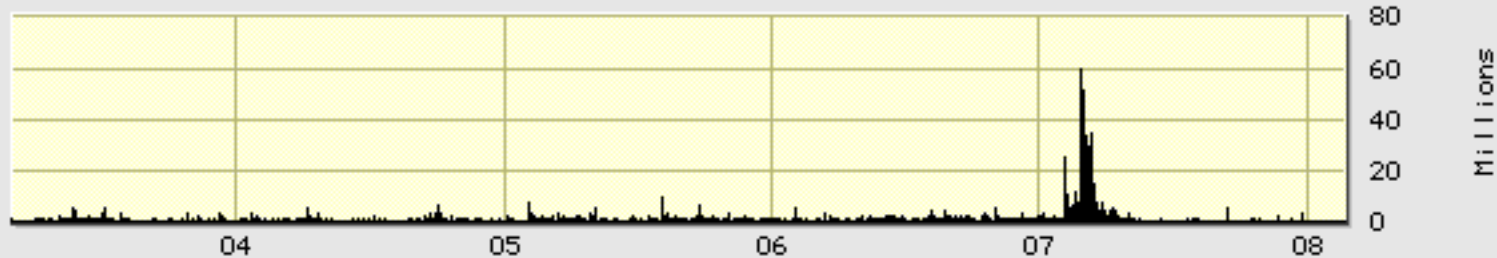
NEWCO Daily

2/26/08



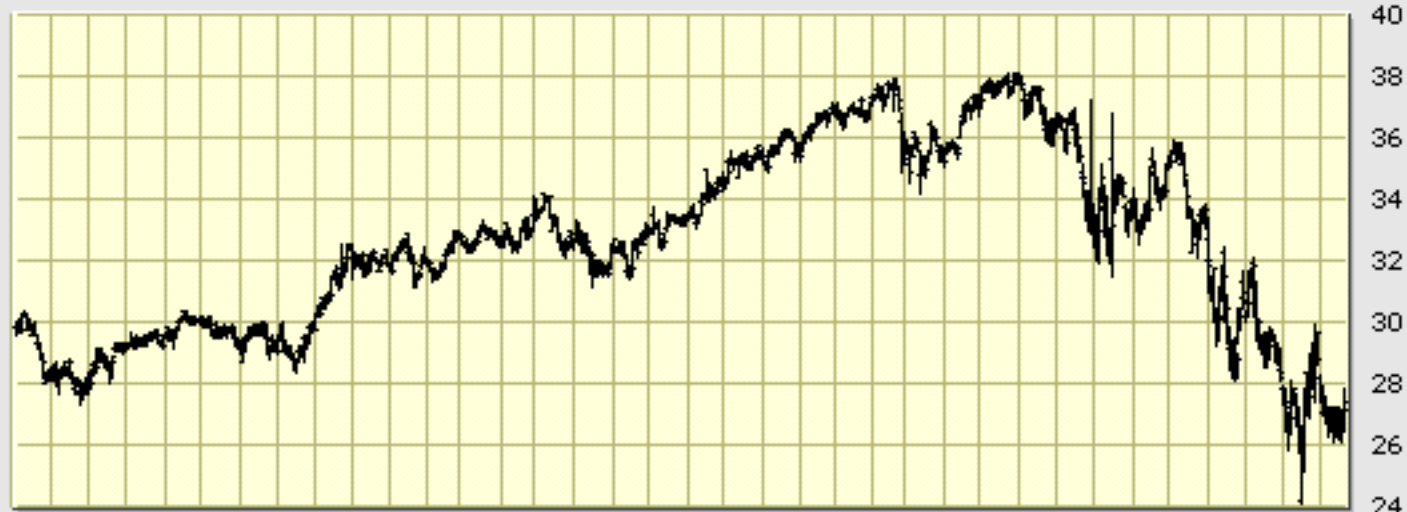
Volume

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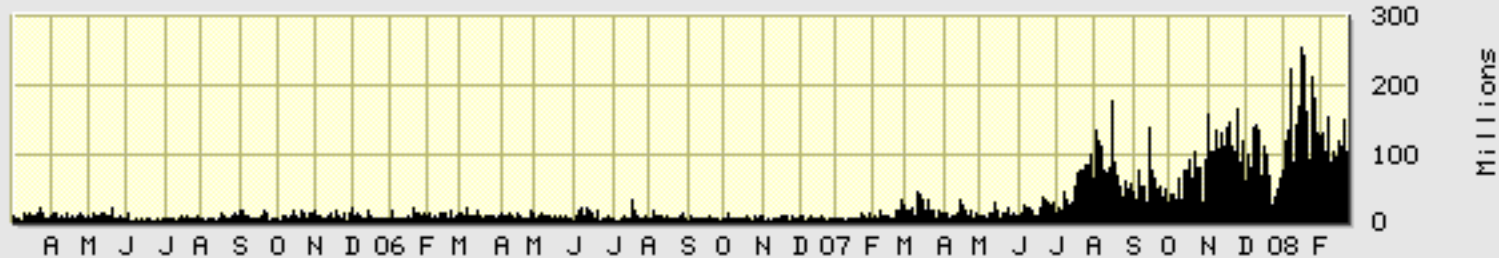
XLF Daily

2/26/08



Volume

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Ripple Effects

- Wealth Effect
- Job Losses

The diminishing 'wealth effect'

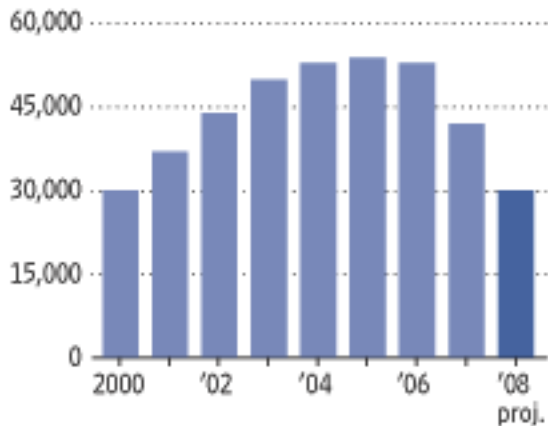
Homeowners in Sacramento and California took out fewer home equity loans and lines of credit last year, a key factor behind the sharp slowdown in consumer spending.

| | SACRAMENTO <i>in millions</i> | | | CALIFORNIA <i>in millions</i> | | |
|-------------------|-------------------------------|-------------------|-------------|-------------------------------|--------------------|-------------|
| | 2006 | 2007 | CHANGE | 2006 | 2007 | CHANGE |
| Jan. | \$528.24 | \$388.04 | -27% | \$9,987.82 | \$7,934.66 | -21% |
| Feb. | \$489.01 | \$343.52 | -30% | \$8,574.32 | \$7,584.55 | -12% |
| March | \$614.75 | \$408.04 | -34% | \$11,258.49 | \$10,081.14 | -10% |
| April | \$538.27 | \$402.49 | -25% | \$10,137.69 | \$9,481.92 | -6% |
| May | \$545.60 | \$365.08 | -33% | \$10,577.88 | \$9,457.44 | -11% |
| June | \$568.71 | \$371.66 | -35% | \$11,016.81 | \$9,064.10 | -18% |
| July | \$486.85 | \$369.00 | -24% | \$10,082.34 | \$8,567.67 | -15% |
| August | \$577.22 | \$364.19 | -37% | \$11,780.82 | \$8,766.94 | -26% |
| Sept. | \$475.32 | \$271.55 | -43% | \$9,839.09 | \$6,868.48 | -30% |
| Oct. | \$486.22 | \$321.32 | -34% | \$10,220.75 | \$7,199.96 | -30% |
| Nov. | \$445.49 | \$256.49 | -42% | \$9,236.05 | \$5,935.01 | -36% |
| Dec. | \$427.47 | \$216.16 | -49% | \$8,966.16 | \$5,376.79 | -40% |
| YEAR TOTAL | \$6,183.15 | \$4,077.53 | -34% | \$121,678.22 | \$96,318.65 | -21% |

Note: December 2007 for state is a preliminary number that doesn't include some small, rural counties. Sacramento includes El Dorado, Placer, Sacramento and Yolo counties. Figures include sums where the line of credit was obtained but not fully tapped.

Shrinking Role

Number of mortgage brokerage firms operating in the U.S.



Source: Wholesale Access

Housing Bust + Ripple Effects = Recession

- “I’ve seen this movie before, and the ending of the movie always ends up in some form of recession” – Angelo Mozilo, CEO Countrywide Financial, August 23, 2007
- Liquidation of malinvestment
- Reallocation of capital and labor
- Analogy to flu or drug addiction: it takes time to work through all the excesses, reallocated capital and labor and build a solid base from which to begin growing again