



# MANCHESTER

CAPITAL MANAGEMENT, LLC

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## *The Laws of Finance*

**By Ted Cronin, CIO**

Inherent in the operation of markets and economies are fundamental relationships that can be ignored for interim periods, but that will reassert themselves eventually. These laws of finance dictate that the present value of any asset is a function of its future cash flows, either an income stream or an appreciated value at sale. What something is worth today is related to what it will eventually deliver in the future.

Bubbles, such as we have witnessed in internet stocks, housing prices, and credit markets, occur with regularity amid a euphoric belief that the laws of finance are flexible. The momentary price of something can be distorted by a crowd which is overly enthusiastic or excessively discouraged about the prospects of an asset. As the future unfolds, and the cash flows or values become apparent, the price adjusts to reality.

Internet stocks became outrageously priced in a mad rush by investors to lay claim to the cash flows from a new technology. These stocks suffered when the limits to growth of the “new economy” were discovered. More recently, real estate prices appreciated at a rate disproportionate to the underlying demand for housing generated by local economic growth. When homeowners discovered that not everybody wanted to, or could afford to, live in Florida, Arizona, Las Vegas, and southern California, prices had to retreat to more realistic values.

The current credit problems exhibit some of the worst excesses. Low interest rates dating from the last recession encouraged outrageous leverage in an effort to accelerate profits. Security houses, such as Bear Stearns, increased their borrowing to 32 times their real capital. When some of those assets began to decline in value and investors withdrew capital, they faced impossible debt they could not afford. Banks are now going through a massive effort to “deleverage”



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such obligations, selling assets at a discount to aggressively reduce their borrowing.

The toxic effect of low rates and excess leverage spread throughout the system and disguised the fundamental risks that existed. Credit was extended to borrowers with tenuous capacity to repay at rates only slightly higher than the highest credit worthy parties, such as the US government. Credit rating agencies, supposedly the best judges of who had capacity to repay, were duped into complacency, if not conspiracy. Bank regulators were asleep in a way only bureaucrats can be, while the banks created obligations off their balance sheets, hiding their real jeopardy.

In truth, risk management is more about the stuff that you don't know than the stuff that you do know. Banks could calculate the value at risk for familiar events, such as a company bankruptcy or change in interest rates. They didn't include in their risk models unexpected events, for example, house prices in America had not declined nationally since the 1930's; some derivative products could be priced when the markets were liquid and trading, but when the markets stopped trading, there was no way to calculate the price and therefore the risk of loss.

Calculating counterparty risk on derivative contracts is perhaps the least exact. Many of these contracts are "over-the-counter" agreements between two parties, and they can be resold or pledged to multiple players in a complex network. Tracking the chain of responsibility and scale of exposure one firm has to their peers is almost impossible. Witness the number of banks that have to repeatedly write-down assets over multiple quarters as they slowly learn what their real liabilities are.

We are still watching the unwinding of the current credit bubble. The laws of finance are reinforcing themselves on the misplaced faith in opaque and incomprehensible derivative transactions. At some point, and we are not there yet, the markets will sort out who really owns what, and how it should be valued. In the meantime, big banks will continue to write off billions, security houses will continue to suffer with what they have created, and



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investors everywhere will continue to question the judgment of these financial players.

The collapse of the credit bubble has set the economy back. Domestic economic growth has slowed to less than 1%, and is possibly negative. Unemployment is rising, although still below historic averages. The US dollar has declined relative to many foreign currencies; it has been put under pressure by the Federal Reserve who has cut interest rates further to forestall a recession. Inflationary pressures are growing substantially, as the cheap dollar imports inflation and make the already high commodity prices, such as oil, even more expensive for US consumers.

I suspect that sometime in the next year or less we will reach a tipping point where all the bad news will turn good. A corollary to the financial law of value is a reversion to the mean from either excess. Free markets contain a self-correcting mechanism that redeploys capital from losing enterprises to winning ones.

Eventually, the write-offs and financial debacles will be behind us. The housing market will stabilize. The US economy will reaccelerate, driven by strong exports and a cheap dollar. The Federal Reserve will raise rates in the face of inflationary pressures. The commodity boom, which has earmarks of its own bubble, will subside as the high prices invigorate new supplies to meet the current demand. The dollar will begin a slow rebound toward fair value with other currencies.

While the odds of the current slowdown continuing for a longer period of time are real, the odds are decreasing with every day that we get closer to uncovering the last write-off. The stock market is trading sideways as it tries to calculate these odds, and will be the best indicator of how much longer the process will take. We have turned our attention to the threats of inflation rather than recession, and we are working hard to understand how best to negotiate what I believe is the more dangerous landscape.



## *Inside MCM*

### **We are Pleased to Welcome Emily Scott and James Bishop to MCM!**



Emily joined our Manchester office in December of 2007 as an Investment Manager. Her previous positions as portfolio manager and analyst were at Factory Point Bank, in Manchester, Vermont, Bingham Legg Advisors in Boston, and Delphi Asset Management in New York City. She began her career as a sell-side analyst with First Albany and Lehman Brothers. Emily received her BA from Colby College and her MBA from Kellogg, with concentrations in Economics and Finance. Outside of work, Emily lives in Pawlet, Vermont where she can be found walking, cross-country skiing, taking photographs, and reading.



James joined the firm in October 2007 as the Information Technology Administrator for our Manchester and California offices. He brings with him a wide range of technological expertise and experience, excelling in networking, server management, and hardware/software design. In his prior position, James managed and operated a complex mid-sized data center and Information Technology department for a community bank. He is a graduate of American Intercontinental University in Buckhead, Georgia with a Masters Degree in Information Technology concentrating in Internet and Application Encryption. Away from the office James can be found enjoying the outdoors, the local gym, or motorcycling and traveling with friends.