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EVERGREEN
CAPITAL MANAGEMENT

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“The search for someone to blame is always successful.”

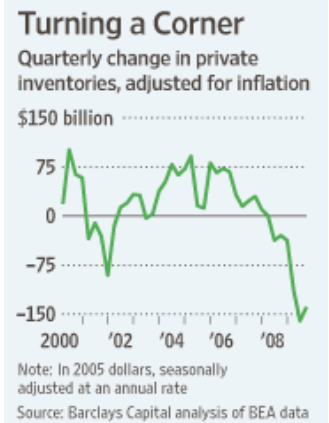
Robert Half, founder of the Fortune 500 company bearing his name

Points to Ponder

1. US GDP surged at a 5.7% annual rate in the fourth quarter of 2009, surpassing even optimistic estimates. The primary driver behind this robust report, contributing 3.4% of the total, was a cessation of inventory liquidations after the longest such streak since 1948.

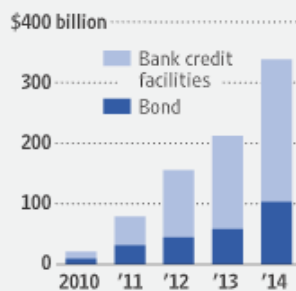
2. It is generally assumed that China's ever growing thirst for oil will force prices higher in the years to come. However, GaveKal Research's Ahmad Abdallah expects that the reduced use of gasoline in the US and Europe will more than offset Chinese demand.

3. Junk bonds produced record returns of over 50% in 2009, driving their yields relative to Treasuries close to normal levels. But junk buyers beware: In addition to continuing high levels of defaults, companies with speculative credit ratings have \$700 billion in debt to pay off or refinance in the next few years.



Debt Balloons Lurk

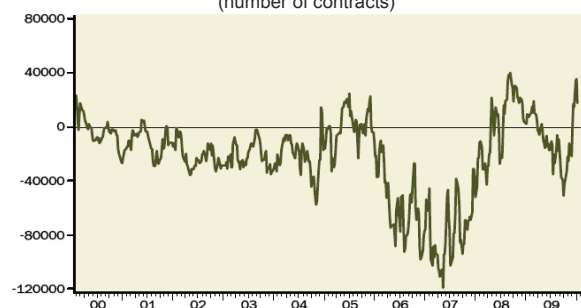
Speculative-grade bank credit facilities and bonds maturing 2010-2014



4. In 2009, US investors continued to pull funds out of domestic stocks, but they plunked \$25 billion into foreign funds. Of this amount, 95% went into emerging markets.

5. Past EVAs have repeatedly made the case that the euro is likely to be a victim of the numerous stresses and challenges afflicting the Continent. Recently, though, bearish sentiment on the euro has shot to a 10-year peak, indicating a near-term rally may occur.

Euro: Net Reportable Noncommercial Short minus Long Positions (number of contracts)



EVALuating the Environment

Murder, they (almost) wrote. Isn't it true that pretty much all of us have a weakness for an intricately woven murder mystery? It always helps when the story involves bigger-than-life characters afflicted with the usual human weaknesses of avarice, hubris, and recklessness.

Nearly all tales about great crimes also involve innocent victims who pay the price for the transgressions of the offenders. And if there are significant sums of money involved, along with conspiracy theories involving the high offices of government, the plot becomes all the more riveting.

But few fictional mystery writers would actually have the wild imagination to conjure up a scenario where all these elements would coalesce to threaten the entire planet's financial system. Yet, that's exactly what happened in the case of one of America's most profitable and globally significant corporations.

AIG, the now-tainted acronym for American International Group, will forever be inseparable from the credit cataclysm that took the world to the edge of a terrifying precipice. What started out as a tiny operation selling life insurance in China after World War I rose to become a Goliath throughout Asia as well as in its home country of the United States.

At its peak valuation in 2000, AIG had a market capitalization of \$240 billion, with more than 120,000 in its employ. As recently as 2006, it was earning \$1.2 billion in after-tax profits—per month! It was the envy of the insurance industry both here and overseas. Yet, save for massive infusions by the US government, it would have been DOA, just another tragic crime statistic.

And make no mistake—killing off AIG, or allowing it to die, would have been a most monstrous crime. Moreover, the victims would have far exceeded the employees and shareholders. Had AIG been left to expire as Lehman did, the ensuing carnage would have been almost incomprehensible. Nearly every resident of the planet Earth would have suffered to some degree. Fortunately, that was not allowed to happen.

Incredibly, however, the emergency triage that was performed under extreme conditions some 15 months ago is now being attacked by those who have plenty of blood on their hands.

Guilty until proven innocent? With the worst of the credit convulsions mostly behind us, it might seem strange to you that I'm dredging up this old, though fascinating, tale. As you've no doubt already noticed, however, those doing the rehashing are the habitual second-guessers who populate Congress.

Their overworked accusatory fingers are once again jutting out at us from TV screens as they have spent much of the last two weeks berating first Fed Chairman Bernanke, then Treasury Secretary Geithner, for their roles in propping up AIG.

Much like grandstanding prosecutors who are intent on conviction regardless of the facts, they are ignoring some rather obvious exculpatory evidence in favor of Messrs. Bernanke and Geithner—like what would have happened had they done nothing.

Apparently, our elected officials believe that holding out for small discounts on the enormous sums AIG owed the world's largest banks was a risk worth taking. Somehow they overlook the fact that events were happening at the speed of light in a vacuum at that time and that any further shock to already shattered confidence could have been devastating.

But perhaps the most remarkable fact the congressional inquisitors are missing is that it is increasingly appearing as though no crime was committed—at least if the measure of that was lasting financial damage to the US taxpayer. But I'm getting ahead of the story line.

Unquestionably, AIG is precisely the kind of situation that makes publicity-hungry DAs salivate. In fact, one of the most culpable actors in this entire tragedy might be the erstwhile attorney general for the state of New York, the now discredited Eliot Spitzer.

The politically ambitious former prosecutor, whose crusading reputation helped him become governor, went after AIG's former CEO, Hank Greenberg, back in 2005 as if he were a 9/11 mastermind. AIG's board, seeking to avoid indictments and an avalanche of bad publicity, forced Mr. Greenberg out even though he was largely responsible for its phenomenal success.

Greenberg was by all accounts no saintly CEO. Cantankerous, imperious, and amply endowed with ego, he was also most definitely an excellent risk manager, both in AIG's core insurance business and with regard to its balance sheet. On his watch, AIG was one of the few corporations sporting the coveted AAA credit rating.

While I'm not qualified to comment on the merits of Spitzer's case against Greenberg, suffice it to say the latter was never convicted of any wrongdoing, while the former was driven from the governor's office in disgrace. It's interesting to consider how things might have turned out had Mr. Greenberg stayed at AIG's helm.

Self-inflicted wounds. The weapon that proved nearly fatal to AIG was that exotic instrument known as a credit default swap. No doubt many of you are still perplexed by what these are and, judging by how badly they mismanaged them, so were many financial institution CEOs.

Therefore, let me provide a brief refresher. Credit default swaps (CDSs) are contracts between two parties whereby the buyer of the contract receives compensation from the seller should the bond or mortgage covered by the transaction default. Thus, a CDS is a form of bond insurance and the buyer pays a premium for this coverage to the seller.

For example, if you owned CDS protection on GM debentures, when it defaulted you would be entitled to a payment, potentially for the full face value of the bond. Because defaults on leading companies are rare, AIG saw a chance to use its fortress balance sheet to earn lush profits with very little risk. At least that's the way it worked out for years. Then things changed in a big way.

In 2005, ironically around the time AIG was in chaos due to the Spitzer/Greenberg wars, the International Swaps and Derivatives Association enacted a significant change in the way CDS contracts were treated. Previously, money only changed hands when a default actually occurred; now it would happen whenever the market price dropped or if the seller of the insurance saw its credit rating reduced.

This change no doubt made sense from the standpoint of making the CDS market safer and more responsive to changing conditions, but it also opened up the possibility of a calamity should market prices somehow become unhinged from reality. Given his attention to detail and proven risk management skills, it's hard to imagine Hank Greenberg not backing away from this business based on these material changes, as did his peer Warren Buffett at Berkshire Hathaway.

The new CEO at AIG, however, had risen through the insurance sales ranks. His affable, marketing-oriented persona was ill-suited to running a fantastically complex financial institution, particularly given the tempest that would soon engulf his company.

Even though AIG employed in excess of 100,000, its financial products division in London numbered just a few hundred. Yet, this comparatively small band sold credit default insurance on nearly half a trillion dollars of debt.

Certainly, the amount of exposure taken on, even for a company AIG's size, was reckless and apparently most of this was in place while Hank Greenberg was still in charge (though, as noted, under very different terms). However, from all the research I've seen (and, believe me, I've spent countless hours pouring over AIG-related reports and articles), its credit underwriting was exemplary. Actual losses have been negligible.

During the utter chaos that ensued after the collapse of Lehman, however, the fact that the bonds AIG had insured weren't defaulting was about as comforting as knowing Bernie Madoff was regularly audited by the SEC.

Unintended consequences. Even though it wasn't that long ago, it's hard for many of us to fully appreciate how surreal the financial markets had become in the fall of 2008. High-quality corporate bonds had fallen by 30% or more and AAA-rated mortgage pools were trading in many cases at 30 cents on the dollar or less.

Under the old rules, AIG and other sellers of CDS coverage would not have been required to put up any cash until the bonds they insured actually failed. But thanks to the changes mentioned above they were now required to put up monstrous amounts of collateral.

This capital outflow, even if temporary and a function of panic-stricken markets, caused the ratings agencies to downgrade them which, per the new rules of the game, meant even more funds needed to be ponied up.

If you think this sounds remarkably similar to the calamitous chain reaction set off by the 2007 mark-to-market accounting change for banks, you deserve extra credit! One of the most defining characteristics of the credit cataclysm was how many related and self-reinforcing things went wrong simultaneously.

Paradoxically, some of the measures that looked good on paper, and that were put into place just prior to the meltdown, magnified the disaster. Due to its CDS exposure, AIG was particularly vulnerable. Fortunately, the government realized that allowing it to fail was not an option.

The price tag for propping up AIG started in the tens of billions but thanks to the feedback loop described above it quickly rose to more than \$100 billion. Even today, it's common to read that the total exposure between the Fed and the Treasury is now \$170 billion.

Determining the true amount all of us are on the hook for with AIG requires some sleuthing worthy of Philip Marlowe and I'll be the first to admit I could be off somewhat. However, I do think the amount actually advanced is \$125 billion, clearly a huge number and almost 20% of the entire TARP fund, but far less than \$170 billion.

The most controversial part of this was the \$33 billion that the Fed invested in AIG's CDS portfolio insuring sub-prime mortgage debt (known as CDOs, for collateralized debt obligations). In fact, this is the transaction for which the congressional critics have recently been haranguing Bernanke and Geithner.

But like all good whodunits, this one has a head-spinning plot twist.

Good news is still no news. US media coverage of the ongoing AIG situation largely centers on bonuses and the aforementioned failure of the Treasury and the Fed to wring concessions from outfits like Goldman Sachs. In fact, were it not for a certain UK newspaper, a belief I've long held would be lacking tangible confirmation.

In a bold headline on the front page of the January 20th edition of *The Financial Times* were the odd words: "Fed makes 'a killing' on AIG Contracts." The article goes on to point out that the Fed's primary investment in the infamous AIG sub-prime CDO mortgage pool was originally \$25 billion (it invested another \$8 billion in a smaller version). Now this is where it gets fascinating.

Due to cash flow from the CDOs, the balance on the Fed's loan is now down to \$17 billion. But what is truly amazing is that on this \$17 billion adjusted capital commitment, the Fed is sitting on a gain of nearly \$19 billion! That's the kind of masterstroke normally associated with Warren Buffett, not a government agency.

This huge gain, admittedly still on paper, came about because the Fed bought these contracts back from the big banks at 50 cents on the dollar. This was after AIG had taken the hit on the drop from \$60 billion to \$30 billion prior to the federal rescue.

As I wrote at the time, due to the fact that the market for the super senior CDOs that AIG had guaranteed was pricing in absurdly high loss assumptions, the Fed was getting a great deal, as is now becoming apparent.

This contention back in the fall of 2008 earned me a few scathing emails questioning my sanity. However, it was my belief, and still is, that given the superior structure of AIG's CDOs (whereby other investors holding the riskiest portions would incur most of the losses), it would be almost impossible for these to be worth less than 80 cents on the dollar.

At today's market prices, these are now worth about 72% of face value, validating my assumption and implying there might be even more upside over time. But, what about the rest of the CDS portfolio?

Remember that the \$60 billion of sub-prime CDOs were a small part of the \$450 billion or so of the total amount of debt AIG had insured. It's my belief that the bulk of the \$125 billion put up by the US government was earmarked to cover the de facto margin calls on that exposure. After all, the rest of AIG was solidly profitable and not in need of cash.

Thus far, there has been almost no information on any recoveries from those contracts, at least that I've come across. However, given that they mostly involved high-grade corporate debt it's nearly certain that these have benefited immensely from the monster rally in the non-Treasury bond market. Therefore, freeing up the collateral posted during the worst of the panic could eventually result in tens of billions of capital being released to help pay back the government loans.

A smart move might be to allow AIG to retain more capital, modifying the mafia-like loan terms of the original deal, in order that it could secure a rating upgrade. This would unfreeze additional billions posted during the meltdown.

Even without that type of strategy, AIG is preparing to sell its crown jewel Asian insurance operations, which are likely to generate proceeds of around \$40 billion. Consequently, based on this and the \$43 billion or so that the Fed has in earnings and market value on the sub-prime CDO portfolio, more than \$80 billion of the \$125 billion is already likely to be headed back to the US government coffers.

Eventually, based on my exceedingly ball park estimates, there should be something in the neighborhood of \$70 to 90 billion of capital liberated from the non-mortgage CDS portfolio, assuming it continues to experience nominal defaults.

The bottom line is that I continue to believe US taxpayers will not only get all of their (our) money back but we're likely to have a tidy profit to show for our troubles and risk. Now, wouldn't that be a shocking ending to this convoluted mystery?



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Our Current Likes & Dislikes

| <i>We Like</i> | <i>We're Neutral On</i> | <i>We Don't Like</i> |
|---|--|---------------------------------------|
| High quality preferred stocks yielding 7%-9 | International developed markets | Real Estate Investment Trusts (REITs) |
| Publicly-traded pipeline partnerships yielding 7%-9% | Longer-term Treasury bonds | Most cyclical resource-based stocks |
| Investment grade corporate bonds | Intermediate Treasury notes | Emerging stock markets |
| Intermediate municipal bonds (with strong credit ratings) | Long-term municipal bonds (with strong credit ratings) | High yield (junk) bonds |
| Emerging bond markets | 3-year to 5-year FDIC CDs | Small Cap Value |
| Large Cap Growth | Gold & gold-mining stocks | |
| Mid Cap Growth | Small Cap Growth | |
| Cash | Large Cap Value | |
| | Mid Cap Value | |

For information regarding sources referred to and used in this article, please contact Kim Harlan at: kharlan@evergreencapital.net

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