INVESTMENT COMMENT — September 7, 2008
U.S. "Takeover" of Fannie Mae and Freddie Mac

This weekend's placement of Freddie and Fannie into conservatorship was the latest, and most-significant, step taken since the Credit Crisis began in July/August of last year. By now many of us may have become numb to the magnitude of announced asset value write-downs, capital raising transactions, and various measures taken by the Federal Reserve and U.S. Treasury. As investors, these numbers are important, but an understanding of the various forces at-work will better serve to ensure that we adhere to a strategic approach to portfolio structure and long-term investing.

Today's action was not a surprise and was authorized by *The Housing and Economic Recovery Act of 2008* as enacted a little over a month ago. Market participants have been awaiting action since US Treasury Secretary Paulson received cartes blanche from this Act to invest in the GSEs (Government Sponsored Entities). The resulting decision announced earlier today has four components:

- **Federal Housing Finance Agency's declaration of conservatorship over the GSEs**
    - Shareholders have lost voting rights and other powers.
    - The GSEs are no longer being managed for the benefit of shareholders – their mission is to make mortgage financing available, albeit at lending standards that have tightened considerably over the last year.
- **Government Sponsored Enterprise Credit Facility (GSECF)**
    - GSECF is a lending facility administered by the New York Federal Reserve to ensure that the GSEs have access to reasonably-priced, short-term collateralized borrowing.
- **GSE Mortgage Backed Securities Purchase Program**
    - Treasury intends to purchase mortgage-backed securities (MBS) in the open market – "…size and timing subject to the discretion of the Treasury Secretary". Treasury has the authority to hold these securities to maturity.
- **Treasury Senior Preferred Stock Purchase Agreement**
    - Provides Treasury with an initial $1 Billion of preferred stock in each GSE that ranks senior to existing preferred stock. This senior preferred stock will have a 10% dividend that "steps-up" to 12% if any quarterly dividend is not paid in a timely manner.
    - Suspends dividend payments to Common and preferred stock holders
    - Provides Treasury with warrants to purchase 79.9% of common stock on a fully-diluted basis.

Each aspect of today's announcement is significant. ***The net result is that the US Treasury has, in effect, become an arbitrageur similar to hedge funds and structured investment vehicles that previously engaged in that business.*** As described in previous Investment Comments[1], the "shadow banking system"[2] as established on Wall Street began unraveling a year ago. The financial system created lending opportunities driven by huge demand from investment vehicles that were structured to purchase loans with significant amounts of borrowed money. That demand has all but vanished, due to impaired asset values of the

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collateral ("packaged" loans). Such vehicles can not continue buying loans and, in many cases, have had to liquidate remaining holdings. The US Treasury has essentially stepped into that business – it can and will issue government-guaranteed debt at rates that will be lower than mortgage rates. Of course, the trick in this business is to properly match the liabilities issued to the loans financed. Since the loans are a "moving target" (mortgagees can prepay, refinance, etc), such asset-liability management is sophisticated work and fraught with miscalculations that can later become substantial errors.

How substantial? Globally, $509 Billion[3] in losses have been announced by financial firms since the Credit Crisis began. To-date, $362.9[4] Billion in new capital has been raised – much of that from foreign, state-sponsored investment funds. Treasury's Plan, if successful, will stabilize or improve the investment values of these firms and allow the banking business to continue the adjustment process from "shadow banking" to more traditional banking.

Selected Asset Classes September 5, 2008	YTD Return
EQUITIES	
US Large Cap Core	**-13.7%**
US Large Cap Value	**-13.8%**
US Small Cap Core	**-5.1%**
US Small Cap Value	**-1.7%**
Large Cap International	**-22.9%**
Emerging Markets	**-25.4%**
ALTERNATIVES	
International Real Estate	**-24.8%**
US REITs	**-1.4%**
Commodities	**-0.3%**
BONDS	
US Treasuries 1-3yr	**+3.1%**
US Treasuries 7-10yr	**+6.3%**
US Treasury Inflation-Protected	**+4.8%**
Mortgage-Backed (MBS)	**+3.1%**
International (Non-US Dollar)	**-0.6%**
EQUITY INDICES	
MSCI World Index	**-18.4%**
S&P 500 ETF	**-14.0%**
BALANCED PORTFOLIOS	
Vanguard 60/40 Fund	**-6.9%**
DFA 60/40 Fund	**-9.6%**

Source: Bloomberg Professional
Note: Returns include reinvested dividends.

Importantly, if the plan works, mortgage availability for credit-worthy borrowers will improve, but it is not clear that mortgage rates will fall. In fact, an argument can be made that the substantial risk-aversion that has driven underlying 10-year US Treasury bond yields well-below 4% would reverse as fears subside – thereby driving mortgage rates higher.

How have globally-balanced, asset class diverse portfolios fared this year? DFA's 60% Stock/40% Bond fund is -9.6%, while Vanguard 60/40 is -6.9%. A 10.3% increase in the US Dollar exchange rate since mid-July is the primary cause of disparity between the two strategies. Of course, client portfolios have customized allocations and generally include diversifying asset classes not found in these funds (ex. Commodities, Inflation-Protected bonds, etc.). Also note the significant divergence of returns within EQUITIES. International and Emerging Markets have fared worst, while US Small company stocks and US REITS have suffered modest, single-digit percentage losses. Equities have done what they often do – discount negative information far into the future. We can not say Treasury's latest plan will mark a turn in equity markets, but, as Warren Buffett said on CNBC recently, "I can't pick bottoms. I don't think anybody can."

[1] See "A Crisis of Confidence in Money Markets" August 21, 2007 and August 6, 2007 Investment Comment available on our website
[2] This phrase was, I believe, coined by a former colleague of mine, Paul McCulley of PIMCO.
[3] Source: Bloomberg Professional service.
[4] ibid.

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