ADDING VALUE

Volume 9: Edition 2 **Second Quarter 2010**

Recently, a viral email was circulating on the Internet. For those of you who need a simplistic, easily understandable explanation of our recent financial crisis, this annotated article should do the trick. We have thought long and hard about adding to this explanation, but determined that any additions would "muddy the waters." Therefore, we will save our response on the best financial reform measures for the economic crisis of 2008 for the next issue of the newsletter. Perhaps then we will have more details of the Administration's proposed reforms.

A TONGUE-IN-CHEEK EXPLANATION OF DERIVATIVE MARKETS

Heidi, a small business owner, is the proprietor of a bar in Detroit. She realizes that virtually all of her customers are unemployed alcoholics, and as such, can no longer afford to patronize her bar.

To solve this problem, she comes up with a new marketing plan that allows her customers to drink now, but pay later. She keeps track of the drinks consumed in a ledger (thereby granting the customers loans).

Word gets around slowly at first, and then with increasing speed about Heidi's "drink now, pay later" marketing strategy and, as a result, an increasing numbers of customers flood into Heidi's bar. Soon she has the largest sales volume for any bar in Detroit. She is so satisfied with her success that she opens more bars, staffed by family and friends in Las Vegas, Phoenix, Miami and Los Angeles. Heidi cannot believe her good fortune.

By providing her customers the freedom from immediate payment demands, Heidi gets no resistance when, at regular intervals, she substantially increases her prices for wine and beer, the most consumed beverages. (She learned this technique at a night class at a business program for small business owners.) Consequently, Heidi's gross sales volume increases massively.

A young and dynamic Vice President at the local bank, who is well versed in the latest quantitative techniques, recognizes that these customer loans constitute valuable future assets. He applauds Heidi's business acumen and is so overjoyed that someone of Heidi's caliber is in his sales area that he increases her borrowing limit. He sees no reason for any undue concern, since he has the debts of the unemployed alcoholics as collateral. He himself fondly remembers some of the parties he attended at Heidi's bar.

At the bank's corporate headquarters, traders can now commingle and strategize with the bank salesmen. During one particular Happy Hour party, the idea was suggested to transform these customer loans into bonds. The party lasted into the night as names were developed…DRINKBONDS, ALKIBONDS, and PUKEBONDS…to name a few. As bonds, rather than customer loans, these securities could then be bundled and traded on international security markets. As luck would have it, there was another party participant in the bar that night—the rating agencies. As the party reached fever pitch, they added to the merriment by granting fake ID's to the newly created bonds.

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

Wright Associates
1500 Oxford Dr., Suite 230
Bethel Park, PA 15102
412-854-2100 (PHONE)
412-854-2550 (FAX)

Naïve investors didn't really understand that the securities being sold to them as AAA secured bonds are really the debts of unemployed alcoholics, and it is unclear that they would have done anything different anyway.

Throughout the summer, the bond prices continuously climb, and the securities soon become the hottest-selling items for some of the nation's leading brokerage houses.

One day, even though the bond prices are still climbing, a risk manager at the original bank decides that the time has come to demand payment on the debts incurred by the drinkers at Heidi's bar. He so informs Heidi.

Heidi then demands payment from her alcoholic patrons. But being unemployed alcoholics, they cannot pay back their drinking debts. Since Heidi cannot fulfill her loan obligations, she is forced into bankruptcy. The bar closes, and her eleven employees lose their jobs.

Overnight, DRINKBONDS, ALKIBONDS, and PUKEBONDS drop in price by 90%. The collapsed bond asset value destroys the bank's liquidity and prevents it from issuing new loans, thus freezing credit and economic activity in the community.

Suppliers of Heidi's bar had granted her generous payment extensions and had invested their firms' pension funds in the various BOND securities. They find they are now faced with not only having to write off her bad debt, but also with losing over 90% of the presumed value of the bonds.

Her wine supplier claims bankruptcy, closing the doors on a family business that had endured for three generations. Her beer supplier is taken over by a competitor, who immediately closes the local plant and lays off 150 workers.

Fortunately though, the bank, the brokerage houses, and their respective executives are saved and bailed out by a multi-billion dollar, no-strings attached cash infusion from their cronies in the Federal Government.

The funds required for this bailout are obtained by the new taxes levied on employed, middle-class, non-drinkers who have never been in Heidi's bar.

Wouldn't it be funny if something like this really happened?

Author: Unknown

Respectfully yours,
Kathleen S. Wright, CFA
A. Gregory Lintner, CFA

Wright Associates
1500 Oxford Dr., Suite 230
Bethel Park, PA 15102