ADDING VALUE

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FINANCIAL REFORM?

Personal qualities that are building blocks for good investing and good regulations:

- *Hard Work and Discipline*
- *Humility*
- *Common Sense*
- *Creativity*
- *Independence*
- *Flexibility*

The Wall Street Reform and Consumer Protection Act crafted by Chris Dodd and Barney Frank is 2,400 pages in length. Looking at the big picture, the grandest goal of the Act is to prevent panics created by an unscripted bankruptcy of a big financial firm. The second investor protection theme in the Act is expanded openness and disclosure, followed by a reorganization of the regulatory authorities. It will take years to judge the new law's success or failure. Generally speaking, however, the new legislation primarily adds more cops, lawyers, and accountants primarily through the Treasury Department, Federal Reserve and the Securities and Exchange Commission. None of these agencies have perfect records. What the new law seems to be lacking is engineers and architects. Rather than creating a public policy system that is the best system of regulation for the U.S. in its current stage of development, we have just added more layers to a regulatory system that was already overwhelmed by minutia. In effect, we will be implementing legislation to micromanage the business of lending, borrowing, and investing. **Again**. It is unclear that any of these cops will ever be able to outsmart the robbers, but time will tell. (Just for the record, it should be noted that Senators Dodd and Conrad, along with a California judge, two former secretaries of HUD and two former Fannie Mae CEOs were among the "friends of Angelo" who got sweetheart mortgages from Countrywide Financial. The irony is inescapable.)

There is no shortage of literature, books, articles, and otherwise, on how to fix Wall Street. Some favorites, probably because we agree with their arguments are written by James Grant, editor of Grant's Interest Rate Observer, Allan Sloan, senior editor of Fortune, Peggy Noonan, author and weekly columnist for the Wall Street Journal, and Charlie Munger, Warren Buffet's partner. Here are some of their observations and the magazine in which their articles appeared. James Grant's article appeared in the April 23, 2010, Op Ed piece in the Washington Post. Some of his observations include: "The substitution of collective responsibility for individual responsibility is the fatal story line of modern American finance…Like one of those notorious exploding collateralized debt obligations, the American financial system is built as if to break down. The combination of socialized risk and privatized profit all but guarantees it. And when the inevitable happens? Congress and the regulators dream up yet more ways to try to outsmart the people who have made it their business in life not to be outsmarted. And so it is again in

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.

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today's debate over financial reform. From the administration and from both sides of the congressional aisle come new accounting rules, higher capital standards, and more onerous taxes. If piling on new federal rules was the answer, we'd long ago have been in the promised land …Until 1999; Goldman Sachs was a partnership, with the general partners bearing general and unlimited liability for the firm's debts. Today, Goldman—like the vast majority of American financial institutions—is a corporation. Its stockholders are liable only for what they invested, no more… The job of Congress is (*should have been*) to bring the fear of God back to Wall Street. Not to stifle enterprise but quite the opposite: to restore real capitalism."

Allan Sloan's article appeared under the title *How to Really Fix Wall Street* in the May 24, 2010, edition of Fortune. His six step program includes: 1.) Demand more skin in the game, 2.) Increase the fear factor, 3.) Expose derivatives to the light of day, 4.) Beef up the bankruptcy laws, 5.) Create a mortgage security data base., 6.) Rein in the credit raters. Specifically, some quotes from the article include: "Our most recent financial crisis, in which a relative handful of U.S. mortgages metastasized into a worldwide financial cancer, started with loans in which the borrowers had nothing or almost nothing at risk… neither did the companies that made the loans and sold them to other companies that bundled them, turned them into securities, and sold the securities to investors." It seems to us that anyone who has some exposure to the outcome will be more careful to analyze the possible outcome. It boggles the mind that AIG could guarantee a staggering $80 billion of subprime mortgage loans without posting any collateral. Are people that stupid? We don't think so—but with no punishment, no accountability, no ramifications, and no embarrassment-why should they rely solely on their conscious?

Peggy Noonan's article appeared in an Op Ed piece in The Wall Street Journal on January 2, 2010. She states: "Wall Street the past 10 years truly and profoundly lost sight of its mission. It exists to be the citadel of American finance. Its job is to grow and invest and enrich, thereby making jobs possible that help families to exist. Wall Street has a civic purpose. But it must always do its job with an eye to prudence, because a big part of its job is to provide a secure and grounded economic footing for the nation. But throughout the 2000's Wall Street's leaders gave themselves over to one thing, and that was looking out, always, for No. 1. And they knew how to define No. 1. It wasn't the country, and it wasn't even the company. They'd crater companies, parachute out, and brag about it later."

Charlie Munger, vice chairman of Berkshire Hathaway, wrote an article entitled "Basically, It's Over", which appeared in the February 21, 2010 issue of Slate. It is self-explanatory, and so depressing that it won't be quoted here. He also gave an exclusive interview to Outstanding Investor Digest, the results of which appeared in the August 9, 2010, edition. He says: "Government is the ultimate referee of residential mortgage quality in the U.S. They had these two giant enterprises, both of which were chartered under federal law and supervised by the OFHEO. And the sole job of the 200 people at the OFHEO was to supervise Fannie Mae and Freddie Mac, both of which were located just a few miles away, essentially right under their noses. And, of course, under the government regulator which had broad power to intervene and stop bad practice, both Fannie Mae and Freddie Mac went hopelessly insolvent. They had phony accounting, some of it caused by the executive's desires to earn very significant bonuses…. So you are not going to solve the problem by just saying "Do whatever you want" to the regulator that's supposed to stop excess. It will be a rare regulator that doesn't get co-opted by the political process or fail through some bureaucratic inertia. After all, the SEC failed totally with Bernie Madoff. That wasn't malevolence, and it wasn't political interference—it was just difficult. Imagine it being difficult to determine that Bernie Madoff was a crook-even after they were told he was a crook by somebody who had pretty well proven it. They ignored it,

because it was difficult. So you are not going to solve all of these problems just by giving more authority to people who've already failed to successfully handle the authority that they already have."

He goes on to say: "I don't think investment banks ought to be allowed to run big derivative books for gambling purposes….After all, if you're permitted to be an underwriter and sell securities to customers, maintain margin accounts for hedge funds, get revenues out of merger advice, and commissions and interest rate spreads, that's a lot of legitimate activity that can easily be done without causing huge amounts of scandal and trouble. Why do these people have to do anything else? They've almost proved that the worst half of them can't handle it. If I were running the world…I would make Paul Volcker look like a sissy."

So with the dawning of a new decade and supposedly an end of an era on Wall Street, it is worth revisiting the principles by which we have built our firm, selected our managers, and managed your money. First, what we do for you, we also do for ourselves. We treat our clients as we would wish to be treated if our roles were reversed. Second, we seek relationships where there is an alignment of interests. Third, we focus on the long term and avoid making short-term speculation. Fourth, we never invest in anything for our clients that we would not be willing to own ourselves. Fifth, we let the opportunities set the level of investment and avoid the lure of market predictions. Sixth, we have tried to keep it simple, focusing our efforts on what we believe to be a tried and proven approach to building wealth. Seventh, we are very cognizant that the price you pay for a security is the final determinant of the return that will be received on the investment.

The mutual fund managers in your portfolios remain committed to similar principles in the management of your assets. More than at any time that we can remember during the quarter century of our careers in which the investing markets have become increasingly bubbly buoyed by ebullient bankers, optimistic investors, ever-tolerant officials, and ultimately, a mortgage mania, these managers have stood by their principles. Robert Rodriguez, who managed FPA New Income and FPA Capital, was one of the first investors who anticipated trouble in the markets. He renounced the debt of Fannie and Freddie early in 2006, scrubbed his bond portfolio free of "suspicious" mortgage-backed securities, and warned of the "Absence of Fear" in his widely acclaimed speech to the CFA Institute in 2007. With 25 years of his direct stewardship of FPA Capital, this fund finished the best of any diversified mutual fund for the period ended 9/30/09 with a return of 14.77%, handily beating the return of the S&P 500 over the same time period of 10.36%.

Mason Hawkins, who runs the Longleaf Partner Funds, has long been an advocate of alignment of interests between the client and the manager. They believe that the capital markets exist to facilitate the transfer of capital between long-term investors and businesses. SEC regulations are designed to promote fair, transparent, and accessible markets. Recent advances in computer technology, however, now allow select short term traders to gain structural advantages over other market participants. The "Flash Crash" of May 6 is an example and one that is still not fully explained. Longleaf has written a letter to the SEC, met with all five of the SEC Commissioners, met with various members of Congress, and testified before the Joint CFTC-SCE Advisory Committee on Emerging Regulatory Issues. Links to this correspondence is available from us upon request or at www.longleafpartners.com. As with letters to the SEC regarding the shenanigans at Madoff's firm, let's hope this action does not fall on deaf ears.

Marty Whitman, Chairman of the Board of the Third Avenue Value Funds and the co-author of Distress Investing-Principles and Techniques wrote in his April 30, 2010, Chairman's Letter that: "It is difficult to function as a value investor unless the value analyst has a firm grasp of

economic reality. It is equally difficult to promulgate intelligent financial regulations unless the sponsors of the regulations have a firm grasp of economic reality. Neither the general public, nor legislators and the Obama administration officials, seem to have much of a grasp of economic reality, at least when it comes to dealing with troubled financial institutions." His letter goes on to discuss eight areas of financial misunderstanding, including how to rehabilitate troubled companies, the phoniness of "too big to fail," the creation of moral hazard by Wall Street and corporate executives, among others.

In summary, we formed our business with high principles and standards, we aligned ourselves and learned from the superinvestors of the philosophy of Benjamin Graham, we adapted and modified our process as we gained more wisdom and as the world changed. Our managers meanwhile continued to enhance their portfolio processes in a similar manner. The final report card from those managers who have long-term verifiable performance records has been exemplary. Without knowing in advance the outcome, some of the managers in your portfolios have literally finished in the top decile of all other managers taken over a 25 year period. That's pretty darned good!!! These same managers have also shown leadership qualities and have attempted to relay their wisdom to governmental authorities but find themselves ignored and abandoned. It is discouraging and frustrating; it's enough to make a grown man cry. Our computer speeds and volume processing capabilities, the sheer number of people pursuing financial management careers, the degradation of our internal moral compass, our inability to use common sense, and the cavalier attitude concerning conflicts of interest seems to have gotten us into a lot of trouble. We need somebody with more sense, someone who knows how to say no, because people are always going to be asking for the wrong things. We need to listen to competent thinkers, not salesman, but we can't seem to tell the difference between the two.

Now and in the coming months, we will start to see some of the regulatory implementation that affects Registered Investment Advisors (RIA's). Documentation will have to be revised for Money Link and IRA Distribution Requests so that there is not a shadow of a doubt about an advisor having custody of assets. Form ADV Part 2, the marketing brochure accepted by the SEC for compliance purposes, will have to be re-written in "plain English," so investors cannot be duped in another Madoff investment scheme. Other regulatory changes are in the offing and will probably be announced before year end. Please bear with us as we try to adhere and understand all the pending regulatory changes.

If a question ever arises, please do not hesitate to call.

Sincerely,

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