

October 2007

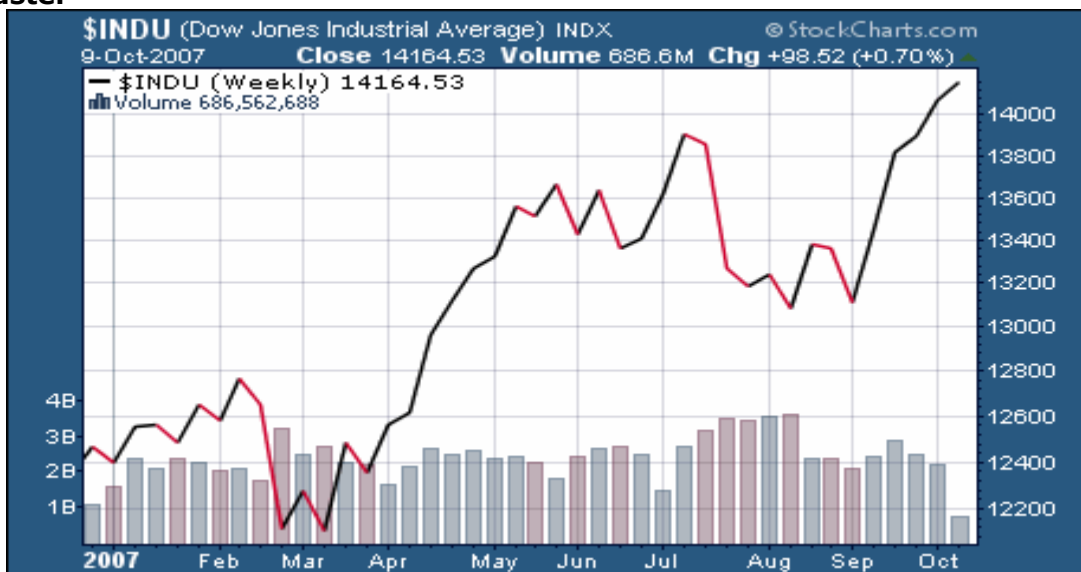
### The Antidote to Worry

***"No one knows for sure where stock prices will go over the next twelve months, but we are confident that the authentic determinants of value – earnings and dividends – are going to rise again by about 10%. We believe this increase in value will, ultimately, be reflected in more new highs for the Dow Jones ...."***  
***(DCM Quarterly Letter, October 2006)***

The above quote was from our October 2006 quarterly letter. When we wrote those words, we thought the operative phrase would be "more new highs for the Dow Jones." Instead, twelve months later it is clear that the operative phrase was "No one knows for sure where stock prices will go . . . ."

Moreover, almost lost in the uncertainties surrounding the recent subprime mortgage crisis and the resulting stock market volatility is the fact that dividends and earnings for the Dow Jones companies, indeed, have grown over 13% in 2007. This solid growth has propelled the Dow Jones Industrials from approximately 12,500 in January of 2007 to over 14,000 as we write this letter - a similar rise of greater than 13%.

### Rollercoaster



However, this exceptional rate of return for stocks has been masked by the route we have taken in getting here. The chart above shows why.

Rollercoaster is the word that best describes the “ride” of the stock market over the past twelve months. This rollercoaster ride has left many investors with a queasy feeling that something is not right. **This queasy feeling has obscured the reality that US business has been very good over the last twelve months, and, indeed, stocks have done a lot better than most people would have believed a year ago.**

The up leg of the rollercoaster ride was caused by the aforementioned strong corporate dividend and earnings growth in the first six months of the year and the realization that inflationary pressures were easing. The down leg of the ride in July and August was caused by soaring delinquencies in subprime mortgage loans and the fallout these bad loans initially had on investors’ confidence in banks and other financial institutions.

## **Real Estate Woes**

We also discussed our concerns about real estate in our October 2006 letter.

**[B]ond investors are predicting [through low yields on long-term bonds] that housing will be very weak. Housing prices have begun to weaken, with prices having fallen the last two months. . . . This is not a pleasant thought, but it is a logical one.**

Despite being on the alert about real estate and even selling many of our regional bank stocks, the swiftness and destruction of the subprime crisis came as a surprise. While there were peripheral stories about troubles at financial institutions that specialized in subprime loans (loans to homeowners with incomplete or low credit scores), the subprime crisis did not appear to extend to the major banks in the US. In late July that was to change. Late in the day on July 24<sup>th</sup>, Countrywide Financial, one of the largest mortgage companies in the US, dramatically reduced their earnings estimates and explained that they were experiencing delinquent loan problems across all credit quality categories. Up to that point, the stock market had been able to shrug off the subprime issue. Now Countrywide’s announcement of widespread mortgage delinquency problems caused the credit markets to freeze up, and ultimately produced a full-blown credit or liquidity crisis.

## **Credit Crisis**

Few investors really understood what was happening when the credit markets first began to freeze up. They only knew that it was a bad thing for the economy and they sold stocks as if there were no tomorrow. This panic selling caused stocks to fall nearly 800 points in the week following Countrywide’s announcement. As more financial institutions started coming clean with the depth of their subprime loan problems, the market continued falling. In the end, the Dow Jones Industrials fell nearly 11% in the 30 days from July 15<sup>th</sup> to August 15<sup>th</sup>.

A true credit crisis is very rare. It has happened only four times in the last 20 years, prior to the current episode:

1. In the days right after the stock market crash of 1987
2. During the Savings and Loan Crisis in 1989
3. During the Asian currency meltdown in 1998
4. In mid-2000 when it became clear the tech bubble was popping

So what is a credit crisis? The answer could fill the pages of a thick textbook, so we will focus on a simple explanation. Since Countrywide Financial started the selling avalanche, let’s use them in our example. All financial institutions have lines of credit with bigger banks that they use to run the day-to-day activities of their businesses. Simply stated, a credit crisis occurs when that line of credit is terminated by the lender.

Countrywide had billions of dollars of assets in loans outstanding, but there might not be anybody paying off an outstanding loan on the day that a new customer wants to borrow for a house. To solve this timing issue, Countrywide would borrow from one of its lines of credit to fund the new loan, and then pay back the loan as funds from their outstanding loans were repaid. Lines of credit are based on an analysis of the quality of a company's balance sheet, which values its assets and liabilities. An issue on most lines of credit is that either party can terminate them at any time. Countrywide Financial was a fast growing, highly regarded company and in a mid-year press announcement they claimed they had \$80 billion in lines of credit, more than enough to carry them through the worst of problems. The problem came after they revealed their worsening loan losses to the investment community. Everyone knew that the value of their assets was called into question, and bank after bank pulled their lines of credit. No line of credit, no new business, and Countrywide was in danger of going out of business.

### **"Countrywide Financial" Crisis or Countrywide Financial Crisis?**

Countrywide's announcement set off selling in all stocks for one very big reason. If the mortgage delinquencies in the subprime market had spilled over into the higher quality prime mortgage market, then every bank in the US was going to take a hit, perhaps a big one. If that were to happen, all banks would be forced to toughen their lending standards, which almost certainly would lead to a recession and lower corporate profits and stock prices.

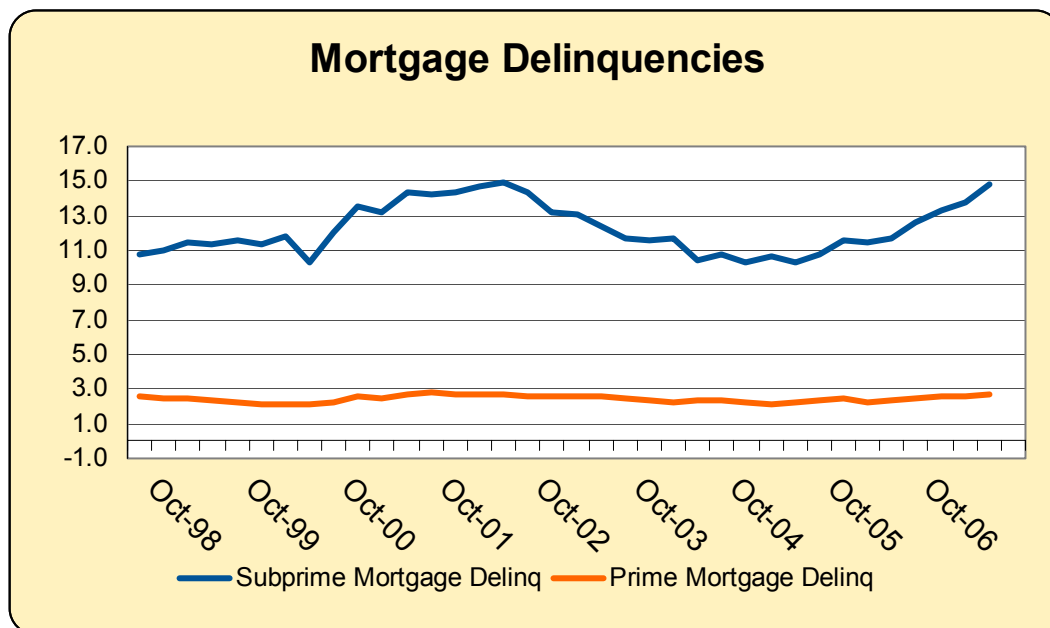
When the market was diving lower during July and August, our Investment Policy Committee meetings in our Strategy Center were intense and frequent. All readers of this letter know that we invest only in what we consider high quality companies with long histories of paying dividends. Our portfolios have made it through all of the previously mentioned credit crises without significant damage, and we have a tremendous amount of confidence in the companies we own. Having said this, our first priority is always to preserve your capital. That means we don't take anything for granted. The tense atmosphere in our Strategy Center was because of one question that needed an answer: Was the banking system in danger of collapse, or were Countrywide Financial's troubles specific to them? If loan losses were as bad at all banks as they appeared to be at Countrywide, then it was possible for a very serious economic contraction to occur.

It might surprise you that we considered such a possibility in late July and early August, but we had no choice. Sometimes we are accused of being too optimistic. Nothing could be farther from the truth. What comes out of our mouths or fingertips has made it through thinking about the possibility and probability of the "worst" happening. Our investment opinions and decisions are honed in the Strategy Center and no action goes unchallenged and no off-the-wall scenario goes unexplored.

We quickly realized that the only way to determine how bad and widespread the delinquency rates on mortgages were was for each major US bank to openly detail the extent of their subprime exposure and their prime loan loss experiences. Having been through these kinds of crises before, we realized that that information was not likely to be available as quickly as we would like. Even though US corporate reporting is the most transparent in the world, there were still important aspects of this sudden crisis that would take more digging to uncover. That meant we had to make our own calculated estimate of the severity of the problem based on the information we could pull from our contacts and investment resources.

### **What We Found**

Early on, we determined that the subprime market was about 13% of the total mortgage loan market in the US. Its rate of growth had been rising rapidly in recent years, but it was still a small percentage of the total outstanding mortgages. Through the help of our Bloomberg Investment Research Terminal, we located data that clearly showed that Countrywide's experience was not the rule.



The chart above shows that the delinquency rate on subprime mortgages (blue line) was near 15% of outstanding loans and rising sharply. Subprime delinquencies were nearly as high as they had been in the time right after the tech bubble popped and 9/11. Importantly, the delinquencies in the subprime market showed no signs of topping. On the other hand, the delinquencies in the prime loan sector (orange line) were not much different than they had been over the last six years. Prime delinquencies were rising, but at a very measured pace and represented only about 2.7% of outstanding prime loans.

This was hard evidence that the mortgage mess was still isolated in the subprime sector and had not spilled over into the prime market. It was also an indictment against Countrywide Financial. If they were having loan losses as broadly as they had announced, it was obvious that they had a lot more subprime loans than they had previously disclosed.

Knowing that the prime loan losses were not spiking higher like subprime loans, however, did not allow us to say that the banking system was safe. If all banks were like Countrywide and had more subprime loans than they had been saying, then there was still a very big problem in the banking system. Having said this, however, we realized, as the previous chart showed, that subprime's 15% loan loss rate on 13% of the total mortgage loans outstanding would not threaten the entire economy.

There were still two big issues: 1) the US and the world were experiencing a credit crisis that could prove disastrous for economic growth; and 2) there was still the possibility that other big banks were much more deeply involved in subprime loans than they had disclosed. When a credit crisis occurs, worries about the creditworthiness of financial institutions will push the interest rates on Fed Funds, which are backed by banks, significantly higher than interest rate on T-bills, which are backed by the government. This signals trouble in the banking system because under normal circumstances the creditworthiness of big banks is thought to be about as safe and that of the US government.

After researching the Fed's response to those four previous credit crises, we became convinced the Fed would cut rates at their September 18 meeting. We believed that such a rate cut would not only remove some of the perceived risks in the banking system, it would also diminish the possibility that the credit crisis would result in a recession.

We resolved the first big issue, but there was still one very big question to answer: Among the bank stocks that we held, had any of them done as Countrywide Financial had and allowed subprime loans to grow to a dangerous level?

We studied all the public statements that our three largest banks—Wells Fargo, Bank of America, and Wachovia—had made about their exposure to the subprime market. Additionally, we listened to the archived recordings of these banks' most recent earnings meetings, with particular interest in the question and answer sessions with Wall Street analysts.

The three banks we studied in detail are among the largest mortgage lenders in the country and none were reporting sharp increases in charge offs or delinquencies. Wachovia indicated they held no subprime loans, and Wells Fargo and Bank of America stated that their holdings of subprime loans were between 5% and 10% of their mortgage portfolios, and an even smaller percentage of their overall loan portfolios. All of these banks were very different from Countrywide Financial, which did not have such a wide array of corporate loans.

The average loan to value ratio of the three banks was 75%. That meant that for them to lose money, all real estate would have to fall by more than 25% in every corner of the country. That was not going to happen. **The stories were so similar from bank to bank that it was clear to us that there was no general banking crisis in this country.**

The final bit of evidence may have trumped all the rest. On July 24<sup>th</sup>, Wells Fargo raised their dividend 11%. On July 25<sup>th</sup>, Bank of America raised their dividend 14%, and on August 21<sup>st</sup>, Wachovia raised their dividend 14%. Dividends are real money and if these banks, which were at the eye of the storm, were raising their dividends by these amounts, it told us that they were signaling that their businesses were in good shape.

There was a credit crisis, but we were confident that the Fed would deal with that; there was a subprime mortgage crisis, but it was not going to topple the big banks. Indeed, it was our belief that the banks we held would come away from the credit crisis even stronger because they had limited their exposure to the subprime market.

By mid-August, we were convinced that the investment prospects for the vast majority of the stocks that we held were not being accurately reflected in their stock prices, and we began to nibble on the stocks we believed were most undervalued.

## **The Market Had it Wrong**

We had done our homework. We had thought through all the "what ifs" we could imagine. We had analyzed the business prospects of every company we owned in light of the unfolding subprime and credit crisis, and we were convinced that the market had it wrong.

You might be saying, "Well it is easy to say that here in October when things have calmed down, but weren't you just a little worried in August when things seemed to be falling apart?" Yes, we were more than a little worried and that is the reason we dug so deeply and slept so little. That is our job; worry is something that people in this business get used to. The antidote to worry is to know the facts, know a lot of the history of the US stock market and economy, and know even more about the companies we own.

To let you know exactly how we felt and what we were saying to our clients at the bottom of the rollercoaster in August, we wanted to share an email conversation between Mike Hull and a friend and client named Bill.

August 12, 2007

Mike –

*My thoughts regarding the financial stocks are as volatile as the market lately. One day everything looks great - the next day it's a disaster.*

*Is there a calmer and more reasoned perspective?*

Thanks,

Bill

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August 12, 2007

Bill,

*You must be setting me up for something. That's ok. I always love your questions.*

*"Is there a calmer and more reasoned perspective?" (than one day everything looks great -- the next day it's a disaster, especially for the financial stocks)*

*I think so. No, of course there is. Absolutely. That perspective lies in what we know, what's inevitable, and what we own.*

### **What We Know**

*We could load up both sides of the bear & bull aisle with what we know and probably make a pretty good case that the economy and the market will find their way to healthy paths. The economic data already collected doesn't show much weakness, outside of housing: While growth in most areas of the economy has slowed, consumer spending continues to grow, as does business investment and industrial production. With a very low unemployment rate and loads of demand from a strong global economy, it would take a housing crash or a run-away credit crunch to throw the U.S. into a recession.*

*Our view from the beginning cast doubts that the housing troubles would be wide-spread. Yes, it's a problem, but the bulk of the problem is falling upon a few large states where sub-prime lending was prevalent and where speculation needed to stop. And, yes, some of the more greedy finance firms fueling this will see their capital evaporate.*

*Has this led to a credit-crunch? Absolutely. Banks are built to protect themselves from risk. Credit will get tight. This won't be fun. Yet, credit-worthy borrowers will still find cash available to them. And that leads us to "What's Inevitable"*

### **What's Inevitable**

*First, both U.S. corporations [banks included] and emerging economies have built up significant reserves over the last five years. Both have accumulated immense and unprecedented profits since 2003. If they need it, capital will be available.*

*Second, at the beginning of last week, Dick Green of Briefing.com said it so well: "The Federal Reserve's first priority is to act as the nation's central bank, and to ensure liquidity in the banking system. If the Fed feels that there is an unwarranted restriction of credit, they will act." In other words -- It's Inevitable. The Fed will not let these credit fears run our economy aground. They just demonstrated that in a big way:*

*1) On Friday, they announced that they stand ready to provide liquidity to banks with unusual or extraordinary credit needs who cannot find funding through normal channels.*

*2) And, they began walking the talk by infusing \$38 billion into the U.S. banking system on Friday. The European, Japanese, Canadian, Australian and other central banks injected nearly another \$100 billion to their banking systems.*

*As Greg said in Friday's blog, the Fed has not stepped in to bail out bad loans; it has stepped in to ensure that the gyrating markets don't cause the banking system to freeze up. Will they do more of the same if they see the need? Absolutely. It's inevitable. It's their job.*

### **What We Own**

*But, while I've danced around it, your question was really expressing concern for the financial stocks. Calling the total return for financial stocks this year (dividends +/- price changes) dismal would be an understatement. The five banks we hold in your portfolio have dropped 9.2% in price. With the dividends received so far, that return has been pared to - 6.8%. And, therein lies the key. The U.S. banking system will survive. It's inevitable. And, I'm betting, as you would, that the five banks you own will still be thriving well after you are comfortably into retirement. The "key" I mean to emphasize here is that whether you are living off this fund or not, we will own these banks (at least four of them) because we want them producing (dividend) income for you. Regardless of where the market takes their prices in the short-term, we believe, as they do, that they will continue to deliver good dividend growth.*

*Over the last five years, those five banks have increased their dividends on a compounded annual basis by an average of 16.8%. They currently have dividend yields between 3.3% and 6.0%, average 4.8%. That alone makes them look like great bargains to the long-term investor.*

*I don't see the risk as whether these banks could see their stock prices drop further this year or not. The biggest risk by far is that you or I would decide we didn't have the patience to watch these volatile stock prices and cash out at these prices.*

*The last thing I want to do is take a Pollyannic approach to this. The reading I've done this weekend shows me that more than a few reputable people watching this truly fear the subprime-loan-housing-bubble-burst-credit-crunch will spread far enough to cause a recession. The Fed's Friday action should help calm the markets, but it may not be enough to calm all the fear that is moving the market. The ride could get even bumpier from here. Yet, that same reading tells me the Fed has enough tools at their disposal to stem the tide and keep the economy on course.*

*This isn't the bursting of the tech bubble in 2000. It is not the Asian Contagion of 1998. It is not 9/11. In each of these instances, the Fed stepped in and kept the banking system lubricated. Ben Bernanke has gone so far in his writings to advise that the 1929 stock market collapse and following depression could have been avoided if the Fed had provided enough liquidity. I have to believe he'll be there for us now, but I believe it will take some patience. This won't end Monday.*

*Mike*

*We included a copy of this email on our weblog ([www.risingdividendinvesting.blogspot.com](http://www.risingdividendinvesting.blogspot.com)) on August 12 with the client's permission.*

### **Where do we go from here?**

We believe the Fed is at an inflection point in their management of the economy. The crisis in the subprime market is their signal that they need to loosen their reins on interest rates. We believe they will lower rates enough to allow the US economy to avoid recession and to keep employment reasonably stable. Core CPI will remain near 2%, which will also allow the Fed room to continue cutting rates. The US economy will slow in the coming months but will begin growing near the optimal rate of 3% by next year at this time.

Corporate earnings will continue to surprise on the upside. This will be primarily driven by the growing global economy, which will be expanding faster over the next year than the US economy. Solid corporate earnings and dividend growth will be aided by the falling US dollar, which makes US exports relatively more competitive in the high growth areas of the world. US companies will also benefit in the domestic economy because the falling dollar makes imports more expensive.

We believe our portfolios are approximately 15% undervalued, with the most undervalued companies continuing to be our holdings of financial stocks. We are convinced that as more

investors recognize the scope of the subprime crisis is limited, they will push the big bank stocks that we own higher.

The subprime mortgage mess will gradually improve through lower interest rates and renegotiation of terms by lenders, who would prefer to cut better deals with mortgagees than to foreclose and try to sell the real estate in a crowded market. Residential real estate will be very slow for some time, due to the excess supply of new homes on the market and the foreclosures that are already in the pipeline. Prices will continue to fall in most areas of the country, especially Florida and California.

### **The Bottom Line**

Falling real estate values and rising adjustable rate mortgage payments are real and major problems for the people directly involved. However, they are only a part of the US economy that otherwise is healthy and landing softly. They are even smaller fractions of a global economy, much of which is actually growing quite strongly. As you know, most of the companies we own have significant businesses outside the US.

We remain confident in the health of and outlook for the companies in your portfolios. And, while continuing to keep an eye on residential housing related companies - and an especially sharp eye on the Fed - we will continue to own the high-quality, rising-dividend companies that have served you so well through good times and through "exciting" times like the past six months.

Blessings,

Investment Committee:

Greg Donaldson      Mike Hull      Rick Roop      Randy Alsman