

Here Comes TARP 3 and 4

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By John Mauldin

What does it mean for Citigroup to be at \$3? As it turns out, it distorts the information we think we are getting from the Dow Jones Industrial Index. And more TARP money is surely in our future, and far more than anyone in authority is now suggesting. This week's letter will cover both topics and a little more. I think you will find it interesting.

Before we get into the letter, just two quick housekeeping items. First, I spend most of my week researching and writing. Part of that process is the ability to call friends and esteemed colleagues to discuss our different points of view about the present markets and economy. I have offered, for the first time, exclusive access for my readers to listen in on those conversations. The first "Conversation" will be with Dr. Lacy Hunt and Ed Easterling next Tuesday, and we will have it ready for subscribers to my new service shortly thereafter. This new subscription service will allow you to listen in on Conversations with me and my friends about the most critical financial and economic topics of the day.

If you ever wanted to be "at the table" when I get to have wide-ranging talks with some of the top economists and investment experts (to be determined, based on where the market takes us, week to week) this is the next best thing. You can still subscribe for one more week at the pre-launch half-off price of just \$99! This is going to be a very powerful, information-packed 45 minutes to an hour where we will weigh in with lively debate and ideas. You will be able to listen online, download to your iPod, or read a transcript. To learn more, just click on <https://www.johnmauldin.com/newsletters2.html>, click the Subscribe button, and type in the code "JM33" at the end of the registration process to get your 50% discount. And read about the bonuses we will offer as well! My staff and Tiffani (partner and daughter) have made me promise this ½ offer will not extend past next week. Don't procrastinate.

Secondly, along with my partners Altegris Investments, I will be co-hosting our 6th annual Strategic Investment Conference in La Jolla, California, April 2-4. I have invited some of the top economic minds in the country to come and address us, giving us their views on what seems to be a continuing crisis. It will be a mix of economic theory and practical investment advice.

Already committed to speak are Martin Barnes, Woody Brock, Dennis Gartman, Louis Gave, George Friedman (of Stratfor), and Paul McCulley. I anticipate adding another stellar name or two. This is as strong a lineup as we have ever had, and on par with any conference I know of anywhere. And as a special bonus, we have invited

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Fredrik Härén from Sweden. I heard him speak at a conference in Stockholm last year and was blown away. You can click on the link below to learn more about the speakers.

Due to securities regulations, attendance is limited to qualified high-net-worth investors and/or institutional investors, because we will be showcasing a select number of commodity fund managers and other alternative strategies. Early registrants will get a discount. Last year we had to close registration, and I anticipate we will run out of room again, so again I would not procrastinate. Click this link to find out more and register: <https://hedge-fund-conference.com/register.aspx>. And if you cut and paste this link, make sure you copy the "https:" so you go to the secure site. And now, to the letter.

Mister Softee is Only Worth 136 Dow Points

Off and on over the years I have written about the distortions that the Dow Jones Industrials creates by using a price-based index rather than a market cap index. As an example, if Microsoft with a market cap of \$153 billion went to a price of zero, all the Dow would lose would be 136 points, or less than 2%. If IBM with a market cap of \$120 billion went to zero, the Dow would lose over 700 points! But it gets worse. David Kotok forwarded this note to me from our mutual friend Jim Bianco (www.biancoresearch.com), which Jim graciously allowed me to reproduce for your edification (prices quoted below are from a few days ago):

“Comment - The Dow Jones Industrial Average (DJIA) is a price-weighted index. The divisor for the DJIA is 7.964782. That means that every \$1 a DJIA stock loses, the index loses 7.96 points, regardless of the company's market capitalization.

“Dow Jones, the keeper of the DJIA, has an unwritten rule that any DJIA stock that gets below \$10 gets tossed out. As of last night's close (January 20), The DJIA had the following stocks less than \$10 ...

Citi (C) = \$2.80
GM (GM) = \$3.50
B of A (BAC) = \$5.10
Alcoa (AA) = \$8.35

“If all four of these stocks went to zero on today's open, the DJIA would lose only 157.3 points.

“The financials in the DJIA are ...

Citi (C) = \$2.80
B of A (BAC) = \$5.10
Amex (AXP) = 15.60
JP Morgan (JPM) = \$18.09

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“If every financial stock in the DJIA went to zero on today's open, it would only lose 331.25 points, less than it lost yesterday (332.13 points).

“If you want to add GE into the financial sector, a debatable proposition, then: GE (GE) = \$12.93

“If the four financial stocks above and GE opened at zero today, the DJIA would only lose 434.24 points.

“The reason the DJIA is outperforming on the downside is the index committee is not doing its job and replacing sub-\$10 stocks, and the financials are so beaten up that they cannot push the index much lower.

“So what is driving the index? The highest-priced stocks:

IBM (IBM) = \$81.98
Exxon (XOM) = \$76.29
Chevron (CHV) = \$68.31
P&G (PG) = \$57.34
McDonalds (MCD) = \$57.07
J&J (JNJ) = \$56.75
3M (MMM) = \$53.92
Wal-Mart (WMT) = \$50.56

“For instance, if all the sub-\$10 stocks listed above, all the financials listed above, and GE opened at zero, the DJIA loses 528.63 points. To repeat if C, BAC, GM, AA, JPM, AXP and GE all open at zero, the DJIA loses 528.63 points.

“If IBM opens at zero, it loses 652.95 points [IBM has risen since then – JM]. So, the DJIA says that IBM has more influence on the index than all the financials, autos, GE, and Alcoa combined.

“The DJIA is not normal as the index committee is not doing their job during this crisis, possibly because to the political fallout of kicking out a Citi or GM. As a result, this index is now severely distorted as it has a tiny weighting in financials and autos.”

You could add Microsoft to the list Jim created and not be over where IBM is today in terms of the DJIA index.

Let's look at it another way. A 10% positive move for IBM would move the Dow up by over 60 points. A 10% move by Citigroup would increase the Dow by less than 3 points. Having stocks with low prices clearly prevents the Dow from declining as much as other market-cap-weighted indexes like the S&P 500.

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But there are other problems with using the Dow. Since 1871, real stock prices (after inflation) have grown at 2.48% while the economy grew at 3.45%. There is almost 1% of "slippage" between the growth of stocks and the economy. Bears could paint a bleaker picture by pointing out that much of the growth was from an increase in valuations. By that I mean, P/E ratios increased substantially. Investors were paying more for a dollar's worth of earnings. The market was valued at an average P/E of 12 (or 20 times dividends) for periods prior to the last bull market. The current valuation levels are still over 20, even after a nasty bear market. Almost 1% of the growth of the stock market over the past 130 years has been due to the recent bubble in prices.

Wait a minute, what about the studies which show the S&P 500 grew at almost 10% a year? Part of the answer is that these indexes include dividends, which averaged almost 5%. You also have inflation, which accounts for a great portion. And part of the answer is that the indexes do not reflect the actual results of the companies. If you measured the Dow or S&P by the companies that were in them in 1950, as an example, the growth would not have been as much. That is not to say the Dow should be fixed. They make the changes to reflect the broad economy, which is what the Dow and other indexes are supposed to do.

That is what makes index investing so attractive in bull markets, and why it is so hard for a mutual fund to beat an index. They keep adding fast-growing companies and getting rid of the dogs. As valuations increase, the funds become self-fulfilling prophecies. But they can have the opposite effect in a bear market, as we now experience.

Nash-Kelvinator, Studebaker, and Other US Giants

For instance, IBM and Coke were added to the Dow in 1932. Coke was dropped for National Steel three years later, and IBM was booted for United Aircraft in 1939. IBM was once again put in the Dow in 1979. Coke returned in 1987. National Steel has long since departed, as has Nash-Kelvinator, Studebaker (I learned to drive in a Studebaker), Woolworth's, and American Beet Sugar. Let's hear it for progress.

For those with no life, or the insatiably curious (I will leave it to you to decide in which category you and I are placed), you can go to http://www.djindexes.com/mdsidx/downloads/DJIA_Hist_Comp.pdf and see the entire history of the Dow.

(As an aside, if anyone knows of a study which shows what \$1,000 invested on October 1, 1928 [when the Dow was expanded to 30 stocks] on a buy and hold would have grown to by today, I would be interested in seeing the study.)

Clearly, buying the component stocks of the Dow and holding them for long periods would not have produced the same returns as the managed index. In fact, the returns would have been rather dismal.

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I would invite readers to think about the implications of this for one moment. While today we might smirk at Nash-Kelvinator or Studebaker or American Beet Sugar, or any of the scores of firms that have been added and dropped from the Dow over the last 125 years, at one time they were considered worthy of inclusion in the most prestigious roll call of companies.

Proponents of buy and hold use indexes to support their claims of its effectiveness. Indexes, however, are not instruments of a strict buy and hold philosophy. They clearly buy and trade. For every GE – which was added to the Dow in 1896 and then dropped in 1898 for US Rubber, and added again in 1899, dropped in 1901, and added yet again in 1907 – there are scores of other firms which were once a part of the mighty Dow and have now faded into oblivion. None of the other companies from 1900 are names which are familiar to me, except as historical curiosities.

Fifteen of the Dow companies have been added since 1990. There are only six stocks still in the Dow that were there in 1940. IBM was dropped in 1939 and was not added back in until 1979. Many of the stocks that have been dropped have gone to zero. If I remember correctly, some 60% of the stocks in the S&P 500 have been replaced in a little over 30 years. In fact, many of the large market cap companies now in the index did not exist 30 years ago.

So, when you buy stocks “for the long run” you are buying stocks selected by a committee (the Dow) or because their market caps increased to a size where they were included (market-cap-weighted indexes). In a very real sense, the S&P 500 is a self-selective growth-stock index.

As an aside, Dow Jones & Co. has no plans to change the companies in its industrial average after four fell below \$10 a share, said John Prestbo, executive director of indexes at the *Wall Street Journal* parent.

“Do I think the Dow is in need of adjustment? No, not at this moment,” Prestbo said. “Those stocks have been in the Dow for a while, most of them, and I think changing horses right now would be the very distortion that some people complain about.” (Bloomberg)

Prestbo has a tough job. As Jim notes, can you imagine the political fallout if the dropped Citigroup or GM right now?

TARP 3 and 4 Are on the Way

There are a lot of complaints about the use of the first \$350 billion in TARP money. How could (now) former Merrill Lynch Chief John Thain have been so tone deaf as to spend \$1.2 million on decorating his office with the company clearly in financial trouble? And some of it apparently after the government was kicking in money? Large bonuses for select managers at the last minute before the merger and subsequent major losses? The list could go on and on. The Obama administration has plans to keep such

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abuses from happening. I wish them luck, because the next round of \$350 billion is just a down payment.

(By the way, we should remember the TARP money is intended to be a loan and not a subsidy. Taxpayers should at least have the chance to come out whole. We will see.)

Professor Nouriel Roubini and his team at RGE Monitor (www.rgemonitor.com) have been noting in speeches in various venues around the world that they estimate that losses from the financial world could be as high as \$3.6 trillion. That is composed of \$1.6 trillion in loan losses and another \$2 trillion in mark-to-market losses of securitized assets.

“U.S. banks and broker dealers are estimated to incur about half of these losses, or \$1.8 trillion (\$1-1.1 trillion loan losses and \$600-700bn in securities writedowns) as 40% of securitizations are assumed to be held abroad. The \$1.8 trillion figure compares to banks and broker dealers capital of \$1.4 trillion as of Q3 of 2008, leaving the banking system borderline insolvent even if writedowns on securitizations are excluded.”

Roubini argues that banks will need an additional \$1-1.4 trillion dollars in private- and public-sector investments. Then he and colleague Elisa Parisi-Capone lay out in detail how they come up with their numbers. They argue:

“Thus, even the release of TARP 2 (another \$350 billion) and its use to recapitalize banks only would not be sufficient to restore the capital of banks and broker dealers to internationally accepted capital ratios. A TARP 3 and 4 of up to \$1.05 trillion (assuming generously that all of TARP 2 goes to banks and broker dealers) may be needed to restore capital ratios to adequate levels.”

Even with all the government money added to the banking system, net capitalization of US financial institutions may fall to as low as \$30 billion, from around \$1.4 trillion before the credit crisis. Let's think about what that means. This same exercise in principal works for England and other European countries. England may be down \$2 trillion pounds, which is relatively much larger than the US losses.

Senators at the Banking Committee hearings which looked into the appointment of Tim Geithner as Treasury Secretary (and kudos to the five who voted against approving him) were outraged at the problem of giving banks all that TARP money and other Fed commitments, and now they were not lending that money and indeed it looks like they want more! I know this will shock some of my foreign readers, but most of the Senators on the banking committee don't really understand the banking system.

Here's the problem. The banks are lending. If you look at bank lending numbers, there is growth. The banks, per se, are not the real problem with the lack of lending. The real problem is that we vaporized an entire Shadow Banking System that bought

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securitized debt in a wide variety of forms: autos, homes, student loans, credit cards, etc. That industry exists no more.

Banks over the last ten years became originators of loans, and not actual lenders. They would make the loans and then package them up for other institutions to buy. A pension fund in Norway (or wherever) would look at the rating from Moody's, see AAA, and buy it. Or banks would create off-balance-sheet vehicles (SIVs) to buy their debt and leverage it up, and book some nice profits. In any event, the debt did not end up on the banks' balance sheets for very long.

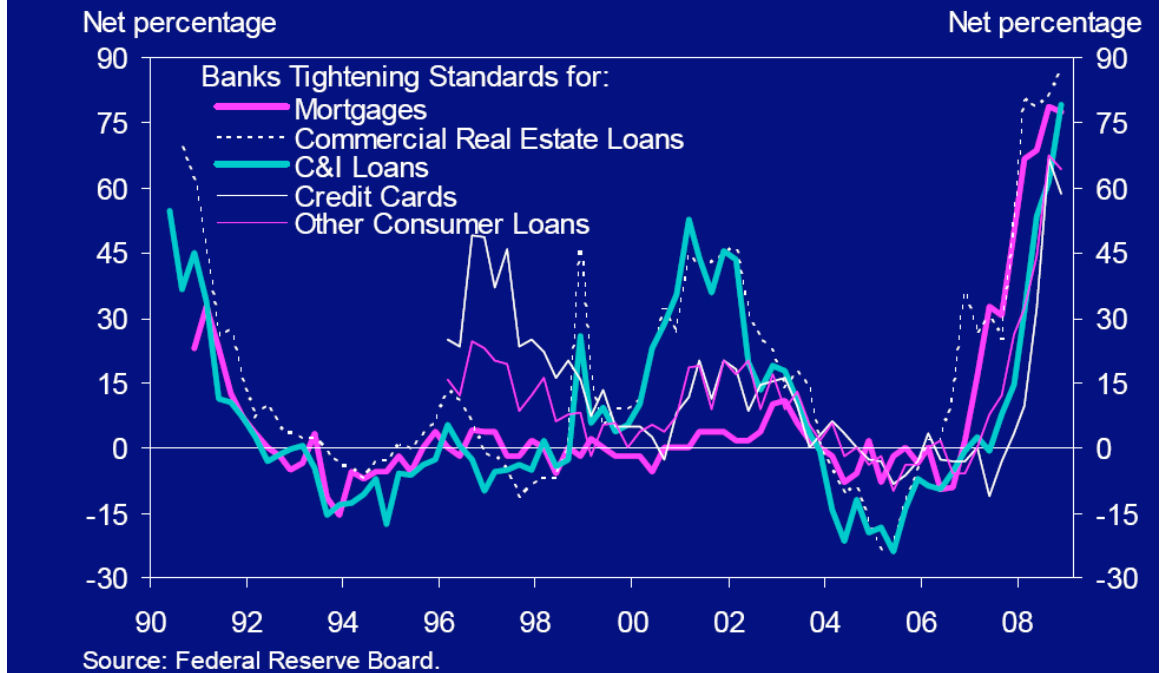
That process was responsible for the majority of debt that was extended over the last decade. Now that process is broken, and it will not be fixed this year or next year or the year after that. We are going to have to come up with new ways of credit creation and debt processing. You can't go to Goldman and tell them to start making auto loans. They simply don't have the people to do that. Now, they used to be able to take auto loans from other actual originators and package them and sell them, but they did not make the loans. And the buyers for much of that securitized auto loan paper are gone. And they are not coming back any time soon without greater transparency and real capital guarantees and higher returns. A Moody's (or any rating agency) rating is not worth the paper, as far as the markets are concerned.

In essence, we are asking the banking system, with greatly reduced capital, to do the heavy lifting that all the buyers of securitized debt did a few years ago. And if Roubini is remotely right, they simply do not have the capital to do it. Further, the banks are in a bind. The regulators, properly so, are making sure that banks have adequate capitalization and are marking assets to real market prices. But they simply have less capital to make loans, even with TARP.

And the loans that many banks have made are showing higher losses than normal. Maine fishing buddy and bank maven Chris Whalen of Institutional Risk Analytics thinks that loan charge-offs will be twice the 1990 level, or around \$800 billion, not far off from Roubini's number. That will force banks to loan less money and raise capital. Not exactly what the Senators want.

And it will force banks to tighten lending standards. Look at this chart from Binit Patel, Senior Global Economist for Goldman Sachs. It tells the story of a banking industry in crisis:

Banks Tighten Standards Dramatically



Notice that the standards for commercial real estate are the highest of all lending standards? And why wouldn't they be, as the banks watch the deals they have done lose value?

Think what a Senate hearing in 2010 would be like if they lowered lending standards and their balance sheets got worse. Senators would be asking how they could put taxpayer money (FDIC) at risk by making risky loans that had now gone bad. And where were the regulators?

(It would be helpful if Senator Schumer in particular stopped grandstanding and actually thought before he made some of the statements he does. People assume he knows something because he represents New York and the large money center banks, and accept his pronouncements at face value.)

Bottom line? It is going to take a lot more TARP and private money to capitalize the banks. A whole lot more. And that is before any of the other stimulus. And all that next \$1 trillion does is get the banks back to where they were two years ago. Further, it does not give them the capital they need to make up for the loss of the Shadow Banking System. It is going to take some time to build what I call the new private credit system. (See my e-letters of August 1 and 8, 2008 in the archives at www.frontlinethoughts.com for an explanation of private credit and how it will be the next big thing in finance.)

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We are going to get what Federal Deposit Insurance Corp. chairman Sheila Bair calls an “aggregator bank,” which will buy bad loans from banks. In an interview with the *Wall Street Journal*, she commented:

“The idea here is that the aggregator bank would buy the assets at fair value. Some are concerned that you’d have to mark the assets down to purchase them, but I think it could help provide some rational pricing, actually, for the market in some of these assets, because we don’t have really any rational pricing right now for some of these asset categories.

“The idea would be to set up a facility, it could be structured as a bank, to capitalize it with some portion of the TARP funds. Financial institutions that wanted to sell assets into the bank could also perhaps take part of their payment as an equity interest in the aggregator bank to provide an additional cushion. If you sold \$1 of assets into the bank, you would get 80 cents in cash and you would get 20 cents in an equity interest in the bank. So that would be an additional cushion against loss.

“With a combination of private equity contributions plus TARP capital, I think you could leverage that into some fairly significant volume to purchase assets.”

This is an idea that she calls “... beyond hypothetical. I think all of the agencies are committed to coming up with a program for troubled asset relief. We’re vetting the various different structures, the pros and cons of those. I think we would all like to have something in place in the not too distant future. I’m hoping the decision making on it would be fairly quick. It has been discussed for some time. So I think we are nearing the point to make a decision. But it’s complicated. We want to make sure we get it right.”

(Interestingly, Prieur du Plessis, my South African partner, writes me at midnight tonite as I am writing this letter: “... have tried registering the domain www.aggregatorbank.com last night, but no luck as somebody has already done this. The price? \$100,000.”)

An aggregator bank (the so-called “bad bank”) is going to happen. So, for what it’s worth, let me make a few suggestions. Banks that are technically insolvent and which will need to put taxpayer money at risk should just be “put down.” The shareholders and bond holders need to be wiped out before taxpayer money is spent. And the banks should be put back in strong private hands as soon as feasibly possible. We do NOT want government agencies subject to political manipulation making decisions about lending. But deals should be structured which give taxpayers a real chance to get their investments back.

And please, no more deals that are not on the same terms that Warren Buffett or other private investors get. That was simply embarrassing for Paulson and team, or should have been.

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In closing, let me quote two paragraphs from Bridgewater Associates that I think sum up the problem in a rather brilliant and clear way, and which I wholeheartedly agree with:

“The root problem is that debts that were incurred to finance assets at high price levels remain in place at their original amounts even though the assets that they financed are now worth far less. Debt that was incurred to finance extrapolated high incomes remains in place at its original amount even though incomes are now much lower. And, debts that were incurred to finance loans remain in place at their original values even though the loans that were made cannot be repaid. Until the debts are brought in line with the assets and the income, there is no moving forward no matter how much liquidity is provided or how eloquent the speech. And, until this happens, the self-reinforcing nature of the debt squeeze will only reduce incomes and asset values further.

“There is no easy way out of a debt restructuring. Someone will have to bear the cost of prior bad decisions. The people who should bear the cost are those who made the bad decisions to make the loans or those who financed the people who made the loans. They intended to profit and would have profited if they were right. But they were wrong, so they should lose. The government needs to allow the losers to lose and focus their actions on minimizing the knock-on effects of their failure on people who didn’t do anything wrong (to minimize systemic risk). They should then take action to minimize the future exposure of the innocent to the future dumb decisions of the small minority, because no amount of regulation will ever eliminate dumb decisions, so you have to plan for them (through much lower bank leverage limits to cushion losses, bank size limits and non-bank entities playing bank-like roles to improve diversification, safety nets to prevent losers from poisoning the whole system, etc.).”

Hear, hear!

Bermuda, Baaad Banks, and Prenatal Vitamins

I have to close with a few humorous paragraphs from my friend Bill Bonner in his essay for the *Daily Reckoning*:

“But if the ‘bad bank’ idea could work, why not create a super baaadddd bank? We could use it to get rid of all our mistakes. Writers could unload their bad novels. Businessmen could sweep their errors under its broad carpet. What the heck, let people get out of bad marriages without penalty; the super baaadddd bank could pay the alimony and divorce costs.

“The hitch with the bad bank idea is so obvious even a banker could spot it. If the cost of mistakes is reduced, people might make more of them. Like the rest of us, bankers are neither good nor bad, but subject to influence. Unlike metallurgy or particle physics, banking does not have a rising learning curve. It’s not science. Instead, it’s more like love and gambling ... with a circular learning pattern. They learn ... and then they forget. They get carried away in the boom upswing; then they get whacked when it turns down.

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“So let them have a good beating. It will give them of a lesson that will last a lifetime ... and give the next generation a solid banking sector.”

I will fly to Bermuda next Wednesday for four days, where I will take a little R&R after speaking for the local CFA group on Thursday and work on the book Tiffani and I are writing. It should be fun.

And speaking of Tiffani, she came in this evening with that “look” on her face. Her best friend had a baby boy this week, and she got to be in the room for the birth. You could see it had impacted her. But I didn’t realize how much.

“Dad, I started prenatal vitamins this week. I am almost 32. That is older than you when you had me. And I want at least three kids. You have a lot of kids, and look how much they mean to you and how happy they make you. I want that when I am your age. I know you want us to wait a little, but it is time. I need to get started.”

Not much arguing with that. Life is going to change. Henry and Angel will have a child this summer. Amanda is getting married, and soon she will get the baby bug. With seven kids my chances for more than a few grandchildren are pretty good. I guess, at 59, being called Papa John will not age me all that much. Maybe it will even keep me younger longer!

Have a great week. And remember that even if a bank won’t give you money, you can always get some love from friends and family, and that is where the real value lies.

Your can’t believe how we throw the word *trillion* around so easily analyst,

John Mauldin