

Who's Afraid of a Big Bad Wolf?

May 9, 2008 Newsletter

The other day I opined ([Level 3 article](#)) that there were an exorbitant amount of Level 3 assets on the books of dealers and banks. I actually wouldn't be surprised if the Federal Reserve owns some after they took a load of stuff off the hands of the broker/dealer buddies. My comments, frankly, were greeted by some cheers and some jeers. Either is OK by me, because my opinion remains the same. If there are no observable inputs to even mark your bonds to a model, good luck selling them. In fact, I saw a huge, \$50 billion bid list a few weeks ago out for the bid. Want to know how many traded? Zip. Zero. Why? Because the bonds were marked at 35 and bids came in at 25. So, this SIV that was being TOLD to sell couldn't sell, because if they had, the result would have been a negative equity situation. I have been trading mortgage backed securities for the better part of 25 years and I had no clue

what levels to place on the bonds. So, yes, that is the Big Bad Wolf that I am afraid of.

The bigger issue, however, is the speed at which level 2 assets are growing. Level 2 assets, according to Bloomberg are 'assets that have quoted market prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model derived valuations in which all significant inputs and significant value drivers in active markets'. This is otherwise known as 'mark to model'. And without further ado, below I will rank companies by their absolute level of level 2 assets and by ratio to total shareholder equity. Now I realize that I may sound like a 'scaredy cat', but hey, in this business, discretion is the better part of value. As absolute return investors, I have to pay attention to something I think could be a problem, even if it never develops, all I have lost is opportunity, not capital.

Level 2 Assets Ranked by Dollar Amount

1. Citigroup	\$1.15 trillion
2. J.P. Morgan	\$1.09 trillion
3. Merrill Lynch	\$1.02 trillion
4. Bank of America	\$781 billion
5. Goldman Sachs	\$620 billion
6. Bear Stearns	\$332 billion
7. Fannie Mae	\$321 billion
8. Morgan Stanley	\$304 billion
9. Prudential	\$276 billion
10. Lehman	\$200 billion

Level 2 Assets Ranked by Ratio to Total Shareholder Equity

1.	Merrill Lynch	28x
2.	Bear Stearns	28x
3.	Goldman Sachs	12x
4.	Prudential	12x
5.	Amerprise Financial	9x
6.	Citigroup	9x
7.	American Electric Power	9x
8.	Genworth Financial	9x
9.	Hartford Insurance	9x
10.	Lehman Brothers	9x
11.	Suntrust	8.7x
12.	J.P. Morgan	8.7x
13.	Anadarko Petroleum	8.7x
14.	Travelers	8.5x
15.	Lowes Corp.	8.5x

Should we be afraid of this Big Bad Wolf? As I said in my piece that was a forecast for 2008 ([I Don't Know Piece, 12-17-07](#)).

Lastly, what bothers me the most is that each

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President

quarter, more assets get moved from Level 1 (mark to market) to Level 2 & 3. This is not a good trend and keeps us cautious.

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