

CFA SOCIETY OF CHICAGO SPEECH – June 28, 2007

Absence of Fear, by Robert L. Rodriguez, CFA

Good afternoon and thank you for this privilege to speak with you today. I'm CEO of First Pacific Advisors, an \$11-billion investment management company located in Los Angeles. I've been in the investment business for 36 years and I've managed FPA Capital and FPA New Income funds for 23 years. I've deployed a classic absolute value equity investment style along with a contrarian investment philosophy. This methodology also applies to my fixed income management process as well. FPA Capital Fund has a very respectable performance track record for 23 years, with an average portfolio turnover ratio of less than 20%. FPA New Income is a high-quality intermediate investment-grade bond fund that can and does invest in high-yield securities. The fund has not had a down year in 30 years and has had positive total returns in every bond bear market.

My talk today, **Absence of Fear**, is a follow up and expansion of the Special Commentary section that appeared in my March 31, 2007 shareholder reports. It will focus on the concept of RISK since there appears to be little concern about risk in the financial markets currently. My goal is not to scare or sensationalize, but to get investors to consider various risks and ask the basic question, "Am I being sufficiently compensated for these apparent risks?"

I will raise issues involving several markets including: housing, fixed income, private equity, hedge funds and equities. I will also raise another issue that my associates and I do not believe is being adequately considered by investors or the public, in general. Finally, I will update you as to what my current strategy is for both my equity and fixed income funds and where we may be finding value. I will then be available for questions, should there be any.

HOUSING

We are concerned that, after many years of an excessively easy monetary Fed policy, a bubble of massive proportions has been created in the housing market. Many experts believe that the housing cycle is at or nearing a trough or at least is at a stable level. We are not of this opinion. We do not believe you inflate prices and demand over at least a decade and then this over stimulation is corrected in barely 18 months. We are of the opinion that this bubble has infected many areas of the financial economy. I will detail more of this in the fixed income portion of my speech.

There have been several studies as to how inflated housing prices had become prior to the present correction. According to the work done by Gary Shilling's firm, home prices would have to correct between 22% and 28% to return to the equivalent of the median asking rent or to the trend line of the CPI. Prior to 1996, both of these measures approximated the rate of increase in home prices. According to Robert Shiller of Yale University, his real quality-adjusted existing house price index would have to correct nearly 45% to bring it back into alignment. My initial reaction to this estimate was one of disbelief and that it appears excessive; however, home prices would appear to have a considerable way to fall, given the high level of total homes available for sale. With nearly 4.5 million homes for sale in 2007, this compares to an average of approximately 2.5 million homes since 1990 or an excess of approximately 2 million homes. Since 1965, the median dollar volume of single-family homes sales as a percentage of nominal GDP has averaged 8.4% versus 16.3% at the 2005 peak, according to Northern Trust Global Economic Research.

FIXED INCOME MARKET

This housing price bubble has infected the fixed income market. As loan underwriting standards deteriorated, more potential home buyers were then able to qualify for a loan. We are seeing the initial effects of this erosion in underwriting standards by the collapse in the prices of sub-prime mortgage securities and the firms that originated them. The sub-prime mess has been detailed quite extensively but not another area—Alt-A. Alternative-A refers to a class of borrowers that cannot qualify for a conventional mortgage. Typically, they are owners of businesses that do not take out income in the form of W-2. They also have limited documentation; however, they have credit scores that are at or near prime credit scores.

Two years ago, we noticed a problem developing in our bond portfolios involving Alt-A securities. Despite having average FICO scores of 718 on the underlying loans, these securities experienced rapidly escalating delinquencies and defaults after just nine months. We sold them since we did not want to wait around to find out the reason why this was happening. Our worst fears were recently confirmed in a study by First American Financial entitled, "First American Real Estate Solutions Report, Alt-A Credit—The Other Shoe Drops?" This

report shows the following changes in underwriting standards between 1998 and 2006, with the major changes occurring in the last two or three years:

- ARM % of originations rose from 0.7% to 69.5%
- Negative Amortization rose from 0% to 42.2%
- Interest Only rose from 0.1% to 35.6%
- Silent Seconds rose from 0.1% to 38.7%
- Low Documentation rose from 57% to 79.8%
- FICO scores were essentially unchanged at an average of 706.

What is interesting is that the origination volumes for the last two years, when the most egregious deterioration in underwriting standards occurred, total more than the previous seven years of originations combined. Of further interest, Dale Westoff, senior managing director of Bear Stearns, Inc., estimates that 25.8% of sub-prime and 41.2% of Alt-A originations were in California; the combination of these total 33.7% of the total sub-prime/Alt-A universe. For 2006, sub-prime/Alt-A represented approximately 40% of total mortgage originations. I reference this Alt-A underwriting data because I believe it reflects the wider trend of underwriting deterioration throughout the entire mortgage universe. Because of a laxness in credit underwriting standards, along with an accommodative Fed, the housing price bubble was magnified and, thus, it has spread into the asset-backed securitizations market.

Securitization Contamination

We have witnessed an explosion in the size and types of securitizations, with mortgage securitizations leading the way. We were on the March 22 call with Fitch regarding the sub-prime securitization market's difficulties. In their talk, they were highly confident regarding their models and their ratings. My associate asked several questions. "What are the key drivers of your rating model?" They responded, FICO scores and home price appreciation (HPA) of low single digit (LSD) or mid single digit (MSD), as HPA has been for the past 50 years. My associate then asked, "What if HPA was flat for an extended period of time?" They responded that their model would start to reek down. He then asked, "What if HPA were to decline 1% to 2% for an extended period of time?" They responded that their models would break down completely. He then asked, "With 2% depreciation, how far up the rating's scale would it harm?" They responded that it might go as high as the AA or AAA tranches. Adding to this appraisal, in a recent study by Joshua Rosner, managing director of investment research firm Graham Fisher & Co., and Joseph R. Mason, associate finance professor at Drexel University, "Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions," they say, "the senior levels of these structures are probably not as safe and secure as the rating companies have said, as an investor would assume, or as regulators are counting on." In an interview, Mr. Rosner commented that whether the top-rated classes of these securities are downgraded, "depends on home price appreciation. It is a strong possibility that there could be downgrades." ¹

The asset quality problems in sub-prime and Alt-A have the potential to affect other areas, such as the collateralized debt obligation (CDO) market, in ways that many of the holders of those securities have little idea of how exposed they might be to unexpected changes in the security's credit rating. It is estimated that U.S. banks have invested as much as 10% of their assets in CDOs, and the Office of the Comptroller of the Currency (OCC) requires that all of those CDOs be investment grade, says Kathryn Dick, deputy comptroller for credit and market risk. She says, "We rely on the rating agencies to provide a rating." ² As Kevin Fry, chairman of the Invested Asset Working Group of the U.S. National Association of Insurance Commissioners says, "As regulators, we just have to trust that rating agencies are going to monitor CDOs and find the subprime." ³ This statement really enhances my comfort level.

Investors have been gobbling up CDOs, sub-prime, Alt-A securitizations because they can earn considerably higher yields than if they deployed the capital into similarly rated corporate debt. The key element of this strategy is the rating assigned to the particular security. Various financial institutions have bought into this thinking. IN OTHER WORDS, A CORPORATE BOND RATING IS EQUAL TO A SECURITIZATION RATING OR A CDO RATING. Encouraging this strategy are the international bank capital rules, established by the Bank of International Settlements, that do not differentiate between types of debt rated securities (corporate versus securitized) other than to require a 0.6% capital allocation for a AAA security and higher capital requirements as the credit rating declines, so that a BBB requires a 4.8% weighting. According to Darrell Duffie, professor of finance at the Stanford Graduate School of Business, "you can't compare these CDO ratings with corporate bond

ratings. These ratings mean something else—entirely.”⁴ While so many investors and regulators are relying on these ratings, the rating agencies take the position, as exemplified by S&P, “Any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision.”⁵ As Joseph Mason, finance professor at Drexel University says, “The ratings giveth and the disclaimer takes it away.”⁶

A recent example of the flawed nature of this market came to my attention when my associate, Julian Mann, showed me a very garden variety LIBOR sub-prime floating rate security. A major pricing service valued this bond at par, while on March 19, 2007, one of the major rating agencies rated this bond A3. To affirm the accuracy of this bond’s pricing, we went to two brokerage firms that traffic in this type of security and requested what their bid might be, if we owned this security. One responded with a \$7 bid. In other words, a 7% of par bid, a difference of 93% to the pricing service. The other firm declined to bid, but they did indicate that, if they were to, their bid would have probably been around this level. Julian has found several other similar examples, so this one does not represent the proverbial “needle in the haystack.”

We believe that many of these models are flawed and give a spurious representation of accuracy. Given the deterioration in underwriting standards, models predicated on prior experience have little value when compared to the data of the last two or three years. In essence, one is assuming a normal distribution curve of data for modeling purposes, while in reality you have data that comes from a highly skewed distribution. We are beginning to see the negative effects of flawed modeling by the growing number of downgrades in the sub-prime sector. This trend is also starting to develop in the Alt-A sector as well. We believe these trends will continue to unfold over the next two or three years and should lead to a retrenchment in the securitization/origination industry. If our assessment is reasonably correct, mortgage credit availability will likely contract and, therefore, exacerbate the housing contraction and its effects upon the general economy. We disagree with the opinion expressed by our esteemed Federal Reserve Chairman Bernanke, when he said in his speech of May 17, 2007 at Chicago’s 43rd annual conference on Bank Structures and Competition, “We believe the effect of the troubles in the sub-prime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the sub-prime market to the rest of the economy or to the financial system.” We will see if this optimistic assessment proves to be the correct one.

We are of the opinion that the distancing of the borrower from the lender has contributed to the development of lax underwriting standards. Each participant, in the securitization/origination process, takes their ounce of payment, but no one truly worries about the underlying credit quality since the loan will be sold. Furthermore, most participants are compensated on volume and not quality of loan originated. In our opinion, “a rolling loan gathers no loss.” Possibly, with so many sub-prime originators failing because of loan put-backs to them, some degree of underwriting discipline will return to the market; however, with so many types of loan originators operating outside of the regulatory system with minimal capital, it is far better to originate a loan, capture the fee, and then get out of Dodge, should the business go bad. One can always return another day.

Finally, the securitization market and the multiplicity of products that have been created have never been truly tested in a major credit contraction like that of 1990-94. This is because most of today’s securitization products did not exist back then. Another risk is how have they been used in various types of leveraged investment strategies? Have the creators of these products structured their operations to be able to handle a contracting market? It remains to be seen how this all works together. One may gain some insight to the potential risk by reviewing the collapse of the manufactured-housing securitization market. After seven years, it is still a fraction of its former size with all the former major originators gone.

Another example of risk knowing no boundaries, on June 1, the Government of Pakistan issued a \$750 million 6.875% of 6/1/2017 dollar denominated bond priced at par and rated B1/B+ at barely 200 basis points above the ten-year Treasury bond yield. The following week in the Los Angeles Times, the headline read, “Musharraf’s grip falters in Pakistan.” The second headline, “Dismay over U.S. support of general.” I guess the market believes the extra 200 basis points of yield spread is sufficient compensation for risk. I think not.

This weakening in credit quality trend also applies to the corporate bond market. High-yield bond spreads are at record lows, with the CCC component of the Merrill Lynch high-yield index at 18%, more than double the proportion ten years ago.⁷ High-yield spreads have declined from nearly 1100 basis points over the Treasury yield in 2002, to barely 240 basis points recently. We believe this narrowing of credit spread is being driven by the near-record low default rates. For this trend to continue, a near “perfect” credit environment must continue. We see virtually no margin of safety for this sector. This narrow credit spread environment is the key driver that is

propelling Private Equity and their bids for companies. As Dan Fuss, manager of the top-performing \$10.7 billion Loomis Sayles Bond Fund, recently said, "I haven't felt this nervous about a market ever."⁸

PRIVATE EQUITY

The Private Equity (PE) industry is flourishing. PE has seen its capital raising rise more than ten-fold between 1990 and 2000, only to witness a temporary pullback in 2002, and then more than double between 2000 and 2006. PE is no different than any other hot investment trend, in that its peak capital raising and capital deployment occurred in 2000, the stock market peak, only to see this process collapse in 2002, the stock market trough. Capital deployment fell from \$270 billion in 2000 to \$49 billion in 2002, per the Leuthold Group. I call this process "buy higher" and then "don't buy lower." Now we've seen PE fundraising rise to new all-time highs and along with that, acquisitions as well. Leuthold estimates that in 2006 \$469 billion in cash acquisitions were announced and/or completed. While this was occurring, valuations have skyrocketed, according to JP Morgan's data.⁹ Between 2001 and 2006, the average EV/EBITDA multiple paid rose 41%, from 6.1x to 8.6x. Leverage increased 54%, with the Average Total Debt/EBITDA multiple rising from 4.6x to 7.1x.

We are of the opinion that PE is pushing the boundaries of prudence and that this trend is elevating valuations in the equity market. It would not surprise us that there will be many other Chrysler situations in three to five years. By that I mean, Daimler-Benz A.G. paid approximately \$36 billion for the Chrysler Corporation in 1998, only to sell 80.1% of its ownership for \$7.4 billion in 2006. Given that this is other people's money, why worry.

HEDGE FUNDS

Since 2000 hedge funds have more than doubled in number, while their assets have tripled. They too are using elevated levels of leverage, as are PE firms and investors in highly leveraged fixed income securities. These funds are heavy users of derivatives. The Global derivatives market grew nearly 40% in 2006—the fastest pace in the last nine years—to \$415 trillion, per the Bank of International Settlements. The amount of contracts based on bonds more than doubled to \$29 trillion. The actual money at risk through credit derivatives increased 93% to \$470 billion, while that amount for the entire derivatives market was \$9.7 trillion.¹⁰ The International Monetary Fund, in its April 2006 Global Financial Stability Report, estimated that credit-oriented hedge fund assets grew to more than \$300 billion in 2005, a six-fold increase in five years. When levered at 5-6x, this represents \$1.5 to \$1.8 trillion deployed into the credit markets. Fitch, in their June 5, 2007 special report, "Hedge Funds: The Credit Market's New Paradigm," says that despite the upward trend in maximum allowable leverage, "notably, no prime broker reported raising margin requirements in response to historically tight credit spreads and growing concerns about the general level of risk-complacency in the credit markets." The report provides a forced unwind example where an initial 5% price decline in the value of a hedge fund's assets could lead to a forced sale of as much as 25% of its assets, assuming leverage of 4.0x (20% margin). They conclude that liquidity risk is among the more important issues facing credit investors. In an era of constrained returns and narrow yield spreads, increased leverage is the solution since volatility is low; therefore, a higher level of leverage may be utilized. We question this logic.

EQUITY MARKET

Enhanced risk taking is widespread here as well. Equity mutual funds are now at or near their all-time record low cash percentage holding of 3.6%. According to the Leuthold Group's data, investors are directing their cash flows to among the riskiest areas of the equity universe—foreign focus equity funds. \$80 billion has flowed into these funds through May compared to \$11.8 billion for large-cap domestic equity funds and a net outflow of \$4.2 billion for small-cap equity funds. This is the second year in a row that the foreign sector has overwhelmed the flows into domestic equity funds. We are of the opinion that investors are chasing the enhanced returns in the foreign sector but do not realize the extent of the risks they may be taking. We see little value in the domestic equity market since we view valuations as being elevated because, in our opinion, consensus profit expectations are assuming unsustainably high operating margins. There appears to be minimal valuation differentiation across most market cap sectors. For example, my value screen just hit a new low in terms of the number of qualifiers. Prior to the recent equity market decline, only 33 companies, with market caps between \$150 million and \$3 billion, were identified out of nearly 10,000 in the Compustat universe. The previous low was 46 this past February, and before that, it was 47 for both January 2004 and March 1998. When the market cap upper limit was expanded to \$150 billion, only ten additional companies qualified. In times past, I would generally get 250 to 400 companies in just the smaller market cap range alone.

ANOTHER RISK

The other risk we see is energy. We have been big bulls on energy and energy prices since 1999. We include ourselves in the Hubert's peak crowd, until proven wrong. For the last several years, the general

consensus has underestimated the long-term price of oil. We discussed this topic at length in our September 2006 Capital Fund shareholder letter. We are now witnessing a potential collapse in Mexican oil production in the Cantarell field. It now looks like the peak for Mexican oil production was 2004. In our discussions with some drilling rig companies, they have confirmed that the Mexican government is either "very concerned" or in a "panic." With approximately 40% of the Mexican government's budget funded by tax receipts from the state oil company Pemex, they should be very concerned.

A recent study by ExxonMobil went back and took all the oil fields discovered and what their initial estimates of proven reserves were and then added all the subsequent oil production that has taken place since the time of discovery. When this was done, the peak in oil discovery was in the early 1960s. After 40 years of the most advanced technology applications, no new major fields have been discovered to reverse the declining trend of discovery. As such, the odds are increasing that many of our older, more prolific fields are at or near their peak production levels. If this assessment proves to be correct, the era of cheap oil prices is over because conventional oil production is in the process of peaking. Should this idea, peaking conventional oil production, become a consensus opinion, what might be the implication of it for the financial markets or the economy? We do not believe this risk has been factored into the valuations for either stocks or bonds.

CURRENT STRATEGY

FPA Capital Fund has over 40% allocated to cash (short-term investment securities) and our largest sector investment is in energy. Preservation of capital is paramount to us in this risky investment environment. We are at a record low number of holdings, with our largest new addition, Rosetta Resources, acquired nearly two years ago. We have added selectively to some of our existing positions, when their prices declined sufficiently to warrant additional ownership. Our most aggressive addition of this type was in July of last year, when we increased our Avnet holding by 40%. Since then, it has risen nearly 150%. We find very little that currently interests us. Given the virtual non-existence of names on the new low list, along with the sparse number of names that qualify from our value screens, I am presently thinking about renaming my fund the Tylenol Fund. I have a saying, "you never know the value of liquidity until you need it and don't have it." When others are having headaches and need Tylenol, in other words, liquidity, we will provide it to them but at a very, very high price.

FPA New Income has a 1.4-year duration with nearly 16% in cash. The Fund's duration has been kept extremely short since the beginning of 2003. On June 11, 2003 we wrote a piece that is on our website entitled, "Buyer's Strike." We have been of the opinion that, with longer-term Treasury bond yields in the 3% to 4% range, there is little, if any, value in the bond market. We have focused our investing in the two-year sector and less. During the fourth quarter of 2002, our high-yield exposure hit our limit of 25%. Today, that exposure is at a record low of just barely over 1%. We see little, if any, value in this sector as well. It would not surprise me to see high-yield credit market yield spreads equal or exceed the peak levels of 2002 again, given the excesses that appear to be occurring in the financing of private equity acquisitions. Our high-quality asset allocation has never been higher, with 90% in AAA and above, and 8.5% deployed in AA. We hold no exotic securitization securities. We have been moving up the credit quality pyramid for the past two years. The bond market's recent decline has just started to provide some level of investment value in the three- to five-year sector of the Treasury curve. We are carefully monitoring this.

SUMMARY

We see most investment sectors as providing little in the way of a margin of safety. The potential risks that we see do not appear to be well considered in the valuations within these sectors. Investors/ speculators, in all sectors of the investment universe, appear to be willing to engage in highly risky strategies or investments. There is a sense of virtually unlimited liquidity in the financial markets presently. We believe this liquidity safety net can be withdrawn without any notice. In many cases, the abundance of liquidity is a function of creative debt leveraging. Like all leverage, it feels wonderful on the upside, but watch out how it can come back to bite you on the downside.

Because of this widespread leveraging, we are quite willing to position our portfolios in a highly defensive posture. This has included changing client guidelines and index benchmarks. For example, the separate account portfolio cash limitations have been increased from typically 10% to about 40%. We are willing to bet our firm and our reputation to be right. This may lead to investor defections, but that is the price one has to be willing to pay to be right. If we are wrong, our clients will earn positive investment returns, just not as positive as our competition. Should we be correct, we will have protected their principal so that we may be able to redeploy it at more attractive valuation levels. Our primary investment strategy is one of principal preservation. We are not opposed to taking risk; we just want to be more than fairly compensated for doing it. We love chaos, conflict and controversy since these create price volatility, investor fear and investment opportunity. As Warren Buffett wrote

on page 8 of Berkshire Hathaway's 2006 annual report, "Be fearful when others are greedy, and be greedy when others are fearful." We are patiently waiting for that period when we can be very, very greedy.

Before closing, I would like to give credit to several of my associates who helped in providing some of the supporting data for this speech. They include: Rikard Ekstrand, Greg Herr, Julian Mann, Pavan Nagpal and Steven Romick. I thank them for their assistance.

Thank you and now I am available for your questions.

¹ Mark Pittman, "Moody's, S&P Understate Subprime Mortgage Bond Risk, Study Says," Bloomberg, May 3, 2007, p.1.

² Richard Tomlinson and David Evans, "CDO Mask Subprime Losses, Abetted by S&P, Moody's, Fitch," Bloomberg, May 31, 2007, p.3.

³ Ibid, p. 1.

⁴ Ibid, p. 4.

⁵ Ibid, p. 5.

⁶ Ibid, p. 6.

⁷ Caroline Salas, "Junk Bonds May Repeat Crash of 2002 on Increasing LBO Credits," Bloomberg, May 15, 2007, p. 3.

⁸ Ibid, p. 1.

⁹ Pershing Square Capital Management, L.P., "Who's Holding the Bag?" May 2007, p.30-31.

¹⁰ Hamish Risk, "Credit-Default Swaps Spur Fastest Derivatives Growth in 9 Years," Bloomberg, May 20, 2007, p. 1.