



Steven Romick's Speech to the Value Investing Congress

Pasadena, CA

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Then the Gods of the Market tumbled, and their smooth-tongued wizards Withdrew, And the hearts of the Meanest were humbled and began to believe It was true That All is not Gold that Glitters, and Two and Two make Four And the Gods of the Copybook Headings limped up to explain it once more.

- Rudyard Kipling, 1919

From *The Dollar Crisis*, Richard Duncan

Introduction

Thank you, Whitney and John, for having me here today. I thought I'd speak on a subject that is more macro than we at First Pacific Advisors have historically been accustomed. However, we believe that we live in unprecedented times such that we cannot just look to the recent past and see an easy way out of the issues we have created for ourselves. We recognize that we are not economists, but feel that to not wrestle with these substantive issues of the day would recklessly endanger the capital entrusted to us. To ignore the crisis of confidence in the world today is the same as investing butt-naked – drafty, and potentially embarrassing.

Outlook

For the last couple of years, my partner Bob Rodriguez and I have communicated our concerns to our investors through shareholder letters, and commentaries. We wanted to make sure they understood why we have let our cash grow to around 40% of our invested assets in our Crescent and Capital funds. Suffice it to say, that what's currently transpiring is, sadly, not a surprise. As long-term investors one might say, who cares, because one cannot time the market. We agree in principle, but we have met few claiming to invest for the long term, who have also proven to have the stomach to handle the downside volatility that brings prices lower than you ever thought possible.

Our cash hoard has not grown because of our top down point of view, but due to our inability to find comfort in the upside versus the downside for the individual investments we analyze. We are not ashamed to admit that the unknowns in this environment scare us a bit – not enough to be disinvested, but enough to make sure that we have enough on the sidelines to survive what the market throws us. We know we lack the skill to pick the bottom, but we sure don't like the idea of picking the middle.

More than two decades of easy money, combined with a deteriorating savings rate that is now negative, magnified by leverage and lax oversight, has created our current predicament – the Housing Bubble and Subprime defaults are just two of the symptoms. As a result, we now expect a deleveraging across all types of domestic lenders, with many international companies similarly impacted, and that a global credit crisis is in its early stages. Less capital and greater regulatory oversight will impact both lenders and borrowers – a combination that can only negatively impact economic growth.

The U.S. Personal Savings rate has declined from the teens just three decades ago, to less than zero today, and that's with the benefit of historically high employment. Adjusted for inflation, the savings rate has been negative since the late 1990s. When combined with the national price of homes declining for the first time since the 1930s, we fail to see how the consumer will not find themselves more negatively impacted as the credit crisis plays out. Since consumption now represents approximately 70% of our Gross Domestic Product, our economy will likely have a commensurate impact. We act as if it is our birthright to consume more than we produce. We have turned into a nation of spendthrifts.

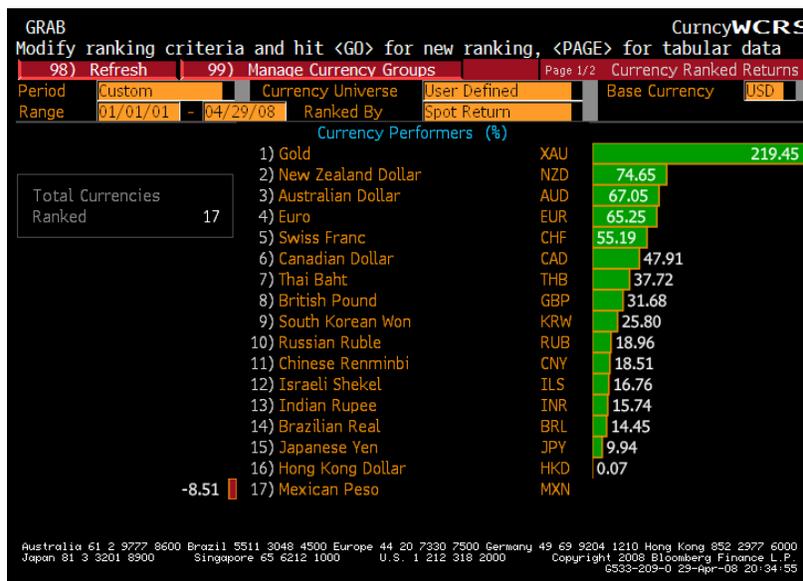


In order to finance a lifestyle that exceeds our capacity to earn, we obviously need to borrow more. Note how the net international investment position of the United States has turned so deeply negative. We are selling our country piecemeal. This means somebody else owns our assets! We still feel rich because we live in a nice country, but each year overseas investors are owning more of the Land of the Free and, as a result, we are effectively forced to pay more rent to live here.



This has not gone unnoticed as the international community has already debased the U.S. dollar. Looking at this chart, the only place you'd want to visit anytime soon is Mexico. Although we do not like the U.S. dollar, we also don't understand why the

pound and euro are trading where they are. It's not like England doesn't have its share of issues – and the euro has never been stress tested since its 1999 introduction.



The President, Congress, and the Federal Reserve are well aware of the problems and are doing what they can. There's a \$150-billion direct injection coming in the form of tax rebates. But, that's not such a big number when you look at it in the context of almost \$2 trillion that entered consumers' pockets through home-mortgage refinancing activity from 2004 – 2006. We look at this as Red Bull economics – get a quick buzz that doesn't last and long term it's unhealthy.

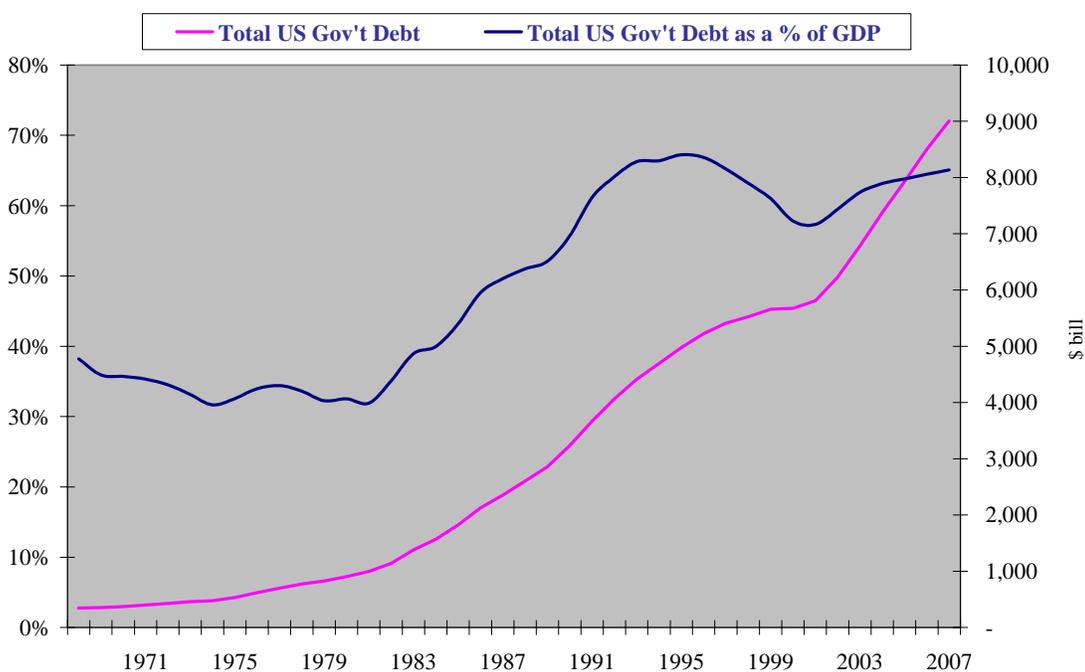
Meanwhile, the Fed has taken aggressive action in using its balance sheet in an unprecedented fashion, not the least of which was its novel assistance in bailing out Bear Stearns, a non-regulated institution. Many have theorized that the Fed had concern that a Bear Stearns failure could have brought down the U.S. banking system. If that were the case, what does that say about the strength of our system when one medium-sized investment bank could inflict such injury?

And, if Bear were about to go out of business, we fail to see why any value remained for the equity shareholder. If institutions believe that the Fed will come to their rescue, then all sorts of financial evil will be attempted and the U.S. taxpayer will pay the price. That hardly seems fair since the majority of the benefit of the unwarranted risk-taking accrued to the benefit of the cavalier corporate executives. As we pointed out in our 2007 First Quarter letter, almost 60% of gross income accrues to the employees of the investment banks and its disbursement is hardly egalitarian. To continue to socialize risk in this fashion practically guarantees that future attempts will be made by the few to benefit on the backs of the many.

We expect continued aggressive Fed and Government intervention to maintain confidence and liquidity in the banking system, in a desire to keep this economic boat afloat, and out of deflationary fears. They are the only ones with the money, and they can always print more – and likely will.

As you can see, U.S. Government debt has grown at a rate that far outstrips our economic growth. The dark blue line is U.S. Government Debt as a % of GDP and the pink line is total U.S. Government Debt. We expect that this graph will look even less appealing over the next few years, as GDP flattens out or declines, while Treasury Debt continues to increase.

U.S. Government Debt



Should unemployment increase measurably, we would not be surprised to see a form of the 1930s government jobs programs. Providing jobs would finally give politicians justification to make sorely needed infrastructure investments.

Eventually though, we will have to repay our debts and the best way to do so is to inflate, that is, use cheaper dollars for repayment. We already believe that inflation is greater than the headline Consumer Price Index number today unless, of course, you don't drive, eat, or require healthcare – so if you are really skinny, healthy and don't care about getting out of the house, you'll be fine. We expect this trend to continue into the immediate future, with higher interest rates as just one potential result.

Investments

We expect that the market will likely show us a number of head fakes as 2008 continues. Beach goers have seen a Great White Shark and they aren't going to enter the water until they're sure that it's safe to swim. Their confidence level will increase commensurate with the time that has passed since the sighting; however, just because a dorsal fin has not been seen for a period of time, that does not mean the shark has left the area. We believe that this shark will be trolling our local beaches for some time to come.

Commercial and investment banks, insurance companies and other mortgage lenders and investors have taken cumulative write-downs in excess of \$300 billion, to date. We do not believe that all such companies have come clean and, until then, we will neither hit bottom, nor have the capability to fully assess the damage to our financial system, and its economic impact. The International Monetary Fund estimates that the total worldwide losses in the financial sector will be just shy of \$1 trillion, but that's with subprime losses at \$45 billion – and we've certainly surpassed that. The SWFs, the Sovereign Wealth Funds – not Single White Females – have been kind enough to inject tens of billions of dollars in equity in order to keep the wheels on the bus, but we can't count on them. And, if they continue to “befriend” us, we accelerate the transfer of our national wealth to our children's detriment.

The markets applauded JPMorgan Chase's recent acquisition of Bear Stearns. We can only agree, as letting Bear fail could easily have led to a daisy chain of negative consequences to our currently fragile financial system. However, the cynic in us has concern (but no evidence) that JPMorgan Chase's actions were nothing more than playing defense. Bear Stearns was reported to have roughly \$14 trillion of derivative exposure, an amount approximately equal to our Gross Domestic Product. Who lies on the other side of those trades? In other words, what counterparties would have been harmed had Bear been allowed to fail? Did JPMorgan Chase buy Bear because they were getting a great deal, or did they buy them to avoid an impairment of their own off-balance sheet derivative transactions? Oh, and how did they get a comfort level with what they were actually buying when they had just a couple of days to perform their due diligence?

JPMorgan has assets of \$1.6 trillion and equity of \$126 billion. They seem reasonably well-capitalized at 7.6%. We just hope that there's no problems in their almost \$92-trillion derivative exposure that is more than 50x their assets and, more importantly, greater than 700x their equity. We hope them to be well-matched, but if they are even the tiniest bit wrong, their equity could be wiped out as their equity represents just 0.13% of their gross derivative exposure.

JPMorgan Chase

Assets	\$1,643
Equity	\$126
Equity/Assets	7.6%
Derivatives (Notional Value)	\$91,734
Equity / Assets + Derivatives	0.1%

Billions of Dollars

Source: Bloomberg Comptroller of the Currency (OCC)

We surmise that additional bank failures will make headlines in the months to come. Financial institutions have been taking on greater risk over the last few decades, both in leverage and complexity of investment, with a veritable alphabet soup of inexplicable (at least to us) investment products – that were made worse by the capital they control both on and off-balance sheet, where the total dollar amount has increased geometrically to the point where our GDP is now dwarfed by such exposure. At the same time, the U.S. government’s regulatory oversight of many such institutions has been increasingly poor, but that hasn’t stopped Congress from passing 1999’s Gramm-Leach-Bliley Act, allowing banks to engage in both commercial and investment banking, prohibited since 1933’s Glass-Steagall Act. We would argue the division between commercial and investment banking holds greater importance today, given the greater regulatory challenge in the increasingly complex world of global finance.

We just pray for well-matched books and solvent counterparties. In the interim, we continue to avoid investments in the financial arena, despite our contrarian nature and what appears to be huge upside potential. We believe the downside for such investments to be just as great as the upside, and believe that future portfolio returns will be dictated by as much of what you do not own, as by what you do.

We keep Japan’s lost decade of the 1990s in mind as we wrestle with what might transpire in the United States, both with respect to its economy and markets. From 1989 to 2003, Japan’s benchmark Nikkei index declined 80%. On the way down, Japanese investors saw eight rallies of more than 20%. In three of those instances, the Nikkei increased more than 40%. And yet, thirteen years later, the Nikkei sat at just 20% of its peak value. We are not projecting such a prospective decline in U.S. stocks. The Nasdaq is already more than 40% off its all-time high. The Nikkei experience of the last

decade certainly reflects what a bumpy, secular bear market can look like. We do expect to see some dramatic, but ultimately ephemeral rallies in U.S. stock indices over the next few years but believe that U.S. market returns will end up in the mid-single-digit range over the next decade.



It may seem easy to just let recent events guide us to our statement that we have yet to see the nadir, but we do not see how we can have hit bottom when companies still haven't come clean. Take Lehman Brothers' persistently generous interpretation of GAAP accounting standards as an example.

Lehman's first-quarter announcement looked good on the surface. In a press release on March 18, they reported \$0.81, beating consensus expectations. *The Wall Street Journal* attributed the 4.2% rise in stock prices that day, in part, to Lehman's earnings release, printing the following headline the next day: "Goldman, Lehman Lift Markets." However, their reported pre-tax income of \$663 million benefited from a \$600 million revaluation of their debt. Lehman, under recent FASB pronouncements, has the ability to reduce their debt under certain circumstances, e.g., if their borrowing cost rises. The marked-down amount will be made up by higher interest expense until either maturity, or subsequent revaluation. So without this "benefit," Lehman would have reported earnings that were barely break-even. Although some analysts mentioned the debt revaluation, none (that we saw) pointed out that they would have missed their earnings wildly without it. With additional information from the 10Q that was filed a few weeks later, we realized that their earnings were even worse than we thought. Level III assets (assets that are marked to model, rather than marked to market) were revalued upwards by \$700 million and Mortgage Servicing Rights were revalued upwards by

\$364 million, or 31%. To our way of thinking, pre-tax income was therefore actually a pre-tax loss of \$996 million, but we hold a minority viewpoint. Although our short position in Lehman was reduced in the \$20s, we have recently increased our stake at current levels.

Lehman Brothers

	Pre-Tax Income ^a	EPS
Q1 '08 Consensus Expectations		0.72
<i>1Q2008 Press Release (released 3/18/08)</i>		
Income (reported)	663	0.81
Revaluation of Debt	(600)	(0.77)
Income (adjusted)	63	0.04
<i>1Q2008 10-Q (released 4/8/08)</i>		
Revaluation of Level 3 assets	(695)	(0.90)
Revaluation of Mortgage Servicing Rights	(364)	(0.47)
Loss (adjusted)	(996)	(1.33)

^aDollars in Millions

We're looking carefully and selectively for companies in which to invest, especially in light of:

- A) A potential financial Armageddon from even a partial unwinding of hundreds of trillions of dollars of off-balance sheet of derivatives.
- B) International economies that are more coupled with our own than many people realize.
- C) Recent complacency regarding risk and prospective market returns.
- D) Macro risks that can disrupt 2008 and/or 2009 estimated earnings such that substantial buying opportunities will materialize.

Nevertheless, we are not 100% in cash. Here are a few investments we consider attractive.

I spoke last year about our large investment in Energy, and spoke specifically about ConocoPhillips. We have maintained our investment in Conoco and the sector as a whole. Those investments range in size from 17 – 24% of our portfolios. We continue to believe an investment in the space is justified given the global supply constraints in the face of increasing demand, as well as it providing both an inflation and U.S. dollar hedge.

Although, Conoco has increased nicely in price, it has clearly disconnected from the price of oil and we remain optimistic regarding its prospects.

West Texas Intermediate vs. ConocoPhillips

5/07 - 5/08



So as not to repeat myself, I thought I'd discuss a couple of other longs in our portfolios, neither of which is a large a commitment but still should prove lucrative longer-term.

The remainder of the presentation is a review of two investment positions.