**Disgusted and Betrayed**

We believe The Housing and Economic Recovery Act of 2008, that was signed into law by President Bush to provide support for up to $300 billion in home loans in financial difficulty and to provide potentially unlimited capital to "bailout and pseudo-nationalize" the GSEs (Government Sponsored Enterprises), is one of the biggest expansions of misdirected policy in the last seventy years. We have witnessed various types of social programs enacted with the idea that they are targeting a specific societal need in that time (e.g., Social Security, Welfare, Medicare). In each case, what was considered a good idea initially expands so as to be financially unsound, forcing society to deal with an ever-growing tab. These programs have resulted in off-balance-sheet liabilities that dwarf the outstanding debt of the United States. Each of these "solutions" has focused on short-term needs without considering their longer-term financial consequences. Similarly, various financial crises have been addressed in this same way ever since the government bailout of Chrysler in 1979-80. Our economic system has been truncated by decision-making predicated on expediency rather than sound, long-range thinking. Market discipline has been trumped by the potential economic fall-out. While the gains benefit the few in the private sector, the losses are borne by taxpayers, rewarding irresponsibility and further emboldening speculators.

We hoped we were witnessing the last of this unsound and unwise thinking and policy-making with the bailout of Bear Stearns just four months ago. The "Bear" was too big to fail and therefore, the Fed helped fashion a rescue plan to protect and save the financial system. We were assured that this would bring stability to the financial markets. Now we have the rescue and support package for the GSEs, Fannie Mae (Fannie) and Freddie Mac (Freddie). It was only on July 10 that Secretary Paulson said that "the lenders (Fannie and Freddie) have sufficient funds" before the House Financial Services Committee. On that same day, the Office of Federal Enterprise Oversight, which regulates both Fannie and Freddie, said that both "are adequately capitalized." Finally, Senator Chris Dodd in a July 11 news conference said, "These institutions are sound. They have adequate capital. They have access to that capital." If these institutions are so sound and well capitalized, why do we need a rescue and support plan that places the taxpayers in a position of unlimited liability? We feel disgusted and betrayed that the socialization of risk continues.

This new law also provides for a new regulatory authority to watch over these GSEs. Excuse us for being skeptical, but our existing regulatory agencies failed to control the excessive leverage building up within our governmental agencies, banks and brokerage firms these past several years. For over two years at First Pacific Advisors, we would not purchase the direct obligations of Fannie and Freddie for our clients since neither agency could file current financial statements because of questionable accounting policies, making it impossible to determine their inherent balance sheet risk. The widespread expansion of financial leverage and uncontrolled growth in derivative securities has increased the systemic risk within the U.S. financial system. When these misguided strategies explode, there is the cry for rescue because the respective financial institution is "too big to fail." This policy of rescue and support has fostered an expansion of reckless risk taking in our financial system. Our feelings are echoed by former House majority leader Dick Armey, who said, "Americans who work hard, pay taxes and play by the rules can't seem to get fair representation in Washington, D.C., these days. In the current debate over a government bailout of speculators, irresponsible banks, Fannie Mae and Freddie Mac, the responsible majority has once again been pushed aside…."

The bailout is not fair and we are not happy about it. Our feelings run the gamut —stunned, disgusted, betrayed, cheated and abandoned. So what can we do now? We know that we cannot control the higher expected taxes, the likely increase in inflation, and slower economic growth that will certainly result from this irresponsibility. What we can control is our resolve to remain true to our investment discipline, our resolve to continue to play by the "rules" in spite of what others do, and our resolve to keep the protection and growth of our client and shareholder assets paramount in our thinking.

We have already communicated many of these thoughts through our previous commentaries (available on our website www.fpafunds.com under "Latest News") with the latest being "Credit Crisis" and "Crossing the Rubicon." We believe our financial and social systems are traveling down a road that will eventually leave our children and future generations financially impoverished and at greater risk to a more volatile and challenging world order. Our elected representatives and regulatory officials, who have supported these misguided policies, will have to bear the responsibility and shame for the weakening of our financial and social systems.

We are not looking to just muddle through this current credit crisis. We must act with an eye to the future. We offer up some thoughts on how to start to climb out of the misdirected-policy-hole we have been forced into with the Fannie and Freddie bailout. With respect to these companies:

- All shareholders (common and preferred) and subordinated debt holders should experience the first losses for any deterioration in business.
- Replace the boards of directors and senior management due to their apparent mismanagement and lack of oversight.
- In their current legal form, they should not be allowed to make political contributions. The conflicts of interest are too great.

- Do not allow these companies access to government financial support other than a 5-year transition period during which the existing senior debt would be guaranteed, but new debt issued would have neither the explicit nor implicit guarantee of the U.S.
- Their capital requirements should be substantially higher than at current levels, and they should be regulated as other similar financial institutions.
- If they are nationalized, a solution which we would not favor, they should be consolidated into one Federal agency and their debt should be included as part of the national debt. The American public deserves full transparency.

These companies should remain independent, without future Federal support, because our government has demonstrated on too many occasions that it has been incapable of managing and controlling these entities. The last time Congress tried to push off and not deal with an impending and growing liability, we were rewarded with the savings and loan crisis, which was a huge draw on the taxpayer's purse. These recommendations are by no means meant to be comprehensive, but merely a starting point for a dialogue regarding Fannie's and Freddie's future. If we do not prudently resolve the Fannie and Freddie challenges now, when will we have the courage to act? We believe maintaining the status quo is unsound, unwise and unacceptable.

The Partners of First Pacific Advisors, LLC

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