



BULLS & BEARS

Volume 2 • Issue 23 • March I 2009

HEADLINES

- GE Slashes Dividend by Two-Thirds
- GDP Slides 6.2% on Slower Spending
- Deal for US Control of Citi Imminent
- Obama Unveils First Budget Plan
- GM Loses \$9.6 Billion

FINANCIAL MARKETS

DOW	7062.93, -4.11%
NASDAQ	1377.84, -4.40%
S&P 500	735.09, -4.54%
OIL	\$44.76, +\$5.82
10 YR	97 23/32, -1 29/32
EURO	\$1.2676

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MARKET SUMMARY

Monday 02/23/09

Investors panicked last week over the notion that major U.S. banks might soon be nationalized, thereby wiping out shareholders' value entirely. Hoping to forestall another brutal sell-off in the market this week, a number of government regulators including the Federal Reserve, the Treasury Department, and the Federal Deposit Insurance Corp. issued a joint statement dispelling the speculation. The government's reassurances contributed to an early morning rally, but did little to soothe the markets. Before the first hour of trading was up, stocks were back in negative territory. The Dow ended the day nearly 250 points lower.

Tuesday 02/24/09

Most stocks gained today, encouraged by comments from Federal Reserve Chairman Ben Bernanke. Appearing before the Senate Banking Committee, the Fed Chief told Congress that the Obama administration was on the right track to heal the ailing banking system, and assured Capitol Hill that he doesn't see a need to formally nationalize banks. Bernanke also predicted the recession would end in the latter half of 2009, but warned that a strong economic recovery isn't possible without first fixing the flagging financial structure. The markets rallied for the first time since the beginning of February and the Dow logged a 230 point gain.

Wednesday 02/25/09

Uncertainty continued to plague the banking sector, as the Treasury Department officially started to administer "stress tests" to the nation's largest financial institutions. Depending upon the results, some banks would receive convertible equity injections from the U.S. government, which only exacerbated nationalization fears. On top of that, the day's bleak economic data did little to ease investors' worries. The National Association of Realtors confessed that sales of previously owned homes fell 5.3% in January, marking the lowest sales pace in 12 years. Meanwhile, the median sales price tumbled to a 6-year low of \$170,300. With economic woes still driving the market, stocks slumped into negative territory and the Dow closed 80 points in the red.

Thursday 02/26/09

General Motors took the spotlight this morning, with the bailed-out automaker confessing to a wider-than-expected loss and warning that it may receive a "going concern" notice from auditors. Stocks shrugged off this downbeat development in early trading, but troubling economic reports continued to stack up throughout the day, and the long-suffering equities market succumbed to gravity in afternoon trading. The Commerce Department reported that new home sales tumbled 10.2% in January to tap a record-low seasonally adjusted pace of 309,000. Also in January, durable goods orders fell 5.2%, marking the sixth consecutive month of declines. On the employment front, the Labor Department noted that initial jobless claims surged last week to 667,000, the highest level since October 1982. Ongoing jobless claims reached a record high of 4.93 million. Finally, investors learned that President Obama's 10-year budget plan forecasts a \$1.75 trillion deficit for fiscal 2009. The Dow tumbled nearly 100 points lower.

Friday 02/27/09

Most U.S. stocks tumbled to new lows from the opening bell. The shares of Citigroup led the march into negative territory, after the financial firm announced that Uncle Sam will increase his direct ownership in the bank to 36%. Not helping matters was the Commerce Department's revised gross domestic product report, which revealed that the U.S. recession deepened more in 2008 than previously reported. More specifically, GDP decreased at a seasonally adjusted annual rate of 6.2% in the fourth quarter, marking the worst quarterly contraction since 1982. The Dow closed 120 points lower, logging its worst February decline ever.

THE WEEK IN QUOTES

"I hope you will now share my view that the losses reported by the bank which you ran cannot justify such a huge reward."

-Lord Myners, British Financial Services Secretary, scolding the former CEO of RBS Fred Goodwin for his refusal to hand back his \$23 million pension

"We're having to scour the thesaurus to find new adjectives to describe just how weak the Singapore economy is."

-Robert Prior-Wandesforde, senior economist at HSBC in Singapore, on news that the country's GDP shrank 4.2% in the last quarter of 2008

"It's the inhumanity of this man — that he can go around depriving people of their livelihoods."

-Eli Wiesel, Nobel Peace Prize winner, on Bernie Madoff, whose Ponzi scheme wiped out \$15.2 million from the Holocaust survivor's charitable foundation

ANNOUNCEMENT

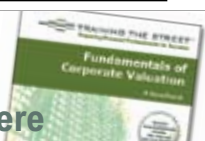
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FRANK & DODD *By Daniel Sholler, University of Pennsylvania*



Barney Frank

Barnett “Barney” Frank, Chairman of the House Financial Services Committee, frequently serves as a liaison between liberal and conservative bases in the House of Representatives. This has become increasingly important given the gravity of the current economic situation. He obtained the position in 2007 and often contributes a voice of dissent, even siding with Republicans on issues such as the Federal Reserve System.

Frank has been regarded as a liberal, energetic thinker who maintains considerable independence in his political ideology. He is a New Jersey native and was educated at Harvard College until 1962, then became an assistant to Boston’s mayor in 1968. In 1971, he began working as an assistant to then-Massachusetts Congressman Michael J. Harrington. This began his congressional career, as he was elected to the Massachusetts House of Representatives in 1972. While serving there, he educated himself further at Harvard Law School, graduating in 1977.

Frank’s nonconformity did not begin with his appointment as Chairman. In 1987, as the 4th Congressional District Representative from Massachusetts, a post he has held since 1981, Frank announced his homosexuality, a first in the House. Since then, he has also advocated many controversial ideas, such as gay, lesbian, transgender, and bisexual rights, the legalization of medical marijuana, pro-choice legislation, free speech, and a reduction of military spending. Frank’s voice of dissent has not always been considered laudable. He was criticized for supporting Fannie Mae and Freddie Mac after receiving considerable campaign funding from the companies and sought less oversight in the government takeover proposal.

Despite the controversy, Frank has played a major role in several crisis plans, many of which involved the housing market. Among the largest was the 2008 American Housing Rescue & Foreclosure Prevention Act, which sought to increase liquidity, provide greater oversight, and increase regulation. Frank conjured a great deal of bipartisan support for the law by working to include ideas from both Republican and Democratic proposals. In similar acts, he has tried to return rights and assistance to middle-class individuals.



Christopher Dodd

Christopher Dodd, Chairman of the Senate Banking Committee, finds himself in a crucial position in combating the current economic crisis. The Committee, which legislates an expansive list of financial matters including banks and monetary policy, has been subject to increasing pressure in the past few months. Dodd, also a member of the Subcommittee on Security and International Trade and Finance, has received a particularly large amount of criticism for scandals involving mortgage companies.

The Connecticut native comes from a rich history of politics and education. His father was a United States Senator and his brother is a professor at Georgetown University. Dodd graduated from Providence College in 1966 with a degree in English literature and later practiced in New London, Connecticut after studying law at the University of Louisville. It was in 1980 that he was first elected to the Senate and has served five consecutive terms. During this time, he also served as General Chairman of the Democratic National Committee and became most well known for advocated child and family issues.

Although Dodd’s advocacy for these issues has brought him considerable praise, his career may be scarred by the controversy surrounding his involvement with the subprime mortgage crisis. He is suspected of using a proposed bailout plan for mortgage lenders to benefit companies like Countrywide Financial. Countrywide allegedly sold homes to Dodd at below-market mortgage rates in return for such beneficial legislation.

Similar controversy has arisen around Dodd’s relationship with Bank of America and its involvement in drafting his legislative proposals. Fannie Mae and Freddie Mac’s recent trouble had Dodd under fire as well. After receiving considerable funding from the enterprises, Dodd allegedly refused to admit the troubles they were facing and criticized Treasury Secretary Henry Paulson’s decision for a federal takeover of the institutions. Dodd’s most recent controversy relates to his involvement with former Bear Stearns executive Edward Downe, Jr. and his home in Ireland, as many accuse the two of conspiring together on several issues.

OBAMA'S BUDGET PROPOSAL *By Wyatt Ozmore, Rutgers University*

Last Thursday, newly elected President Barack Obama announced his bold and aggressive budget proposal to the world. In opposition to the typical circuitous speeches, the President's plan was frankly stated as he projected to spend \$3.6 trillion in the year 2010 alone. With an estimated \$1.2 trillion, or a third of it, being borrowed and added directly to our government's increasing deficit. While conservative members of congress continue to worry about long run effects such as crowding out, more liberal members and their Keynesian counterparts believe on minimizing short-term losses and worrying about long-term issues after a recovery. However, even the dominant democratic base in Congress is not conveying too much optimism for Obama's dramatic measures.

The budget proposal lays out a plan true to Obama's goal of raising the standard of living for low and middle class citizens. Planning to increase taxes on those with the highest income, Obama also hopes to cut Medicare spending to allow for \$634 billion to be designated for his universal health care initiatives. Whether or not the idea of progressive taxes is something you support, this redistribution of wealth as a role of the United States government has been the center of debate for decades. The ongoing struggle between efficiency and equity has led to the formation of disparate political parties and is still evident in the arguments stirred by Obama's budget plan. Some economists believe that raising taxes will decrease incentives to work, but even this idea is not certain. Venturing back to microeconomics can reveal how the cost of leisure shifts as a result of wage changes. Sometimes one may enjoy more leisure with higher taxes, as the opportunity cost of relaxing is lower, but another person may instead work longer hours to reach the same level of income as he or she received before the tax hike.

Since President Ronald Reagan began the age of cutting taxes in the eighties, the incomes of the richest have increased dramatically while the low and middle-classes have seen little gains. Obama argues that this will have

to change in order for this economic crisis to be endured. Furthermore, many economists support the President's argument that the country's overall wealth has tended to be greater with a flourishing middle class. "Throughout our history," says President Obama, "the United States has grown and prospered when all Americans have shared in the opportunities created by our economy." While focusing on current spending to rid ourselves of this crisis, Obama eventually seeks to cut the federal deficit in half by 2013. Such prospects can certainly allow us to expect higher taxes on the wealthy and perhaps lessened tax cuts on the low and middle classes.



The budget proposal also focuses on agriculture and education. First, it will eliminate farm subsidies for those with annual sales greater than half a million. Secondly, Obama hopes to tackle the problem of rising costs of education. The budget proposes to expand Pell Grants and Perkins loans, which are two programs designed to aid low-income students. The President hopes to hand down Perkins

loans to over 2.7 million students. The plan will also make the \$2500 American Opportunity Tax Credit, which was first passed with the recent stimulus bill, a permanent expenditure on the government's part of aiding families with college students.

Finally, the new budget laid out a plan for decreased reliance on foreign oil. Obama also seeks to fight pollution and raise revenue through selling pollution caps to companies. These increased costs of emission will hopefully increase the demand for alternative energy. The expansion of this sector would create millions of jobs for American workers in addition to generating the positive externalities on the environment. The President's budget proposal certainly has a long way to go before being passed by Congress. In time we shall see what exactly is accepted and what agreements must be made.

THE BUSINESS OF TIGER WOODS *By Daniel Sholler, University of Pennsylvania*

The Professional Golf Association has found the answer to the current economic crisis.

OK, so this is a bit of a stretch. However, the impact of Tiger Woods's return to competitive play following knee surgery last June has created a considerable buzz across the business world. Woods, the world's number-one ranked golfer, has become a household name not solely because of his trademark "Tiger Pump" or his 300+ yard drives. His advertising power has out-matched sports and entertainment's most prominent figures, emerging as one of the most marketable individuals in the world today.

Despite losing in the second round of the World Golf Championships-Accenture Match Play Championship in Tucson, Arizona, Woods's force was felt immediately. Prior to his announcement that he would be playing in the tournament, the WGC reported \$400,000 less in ticket sales from last year. The ratings differences were immeasurable—Nielsen media reported a net ratings drop of 46.8% for golf tournaments without Woods.

Woods's return boosted viewership to an estimated 1.8 Nielsen rating, which doesn't take into account the estimated 2.5 million video streams online for the first round of play. This is welcomed news for the PGA and its sponsors, each feeling the impact of the economic crisis as much as any sports and entertainment organization.

While this boost is vital to the prosperity of the PGA, television ratings do not compromise a fraction of Woods's media influence. Over the past few years, he has become one of the biggest advertising moguls in history. Nike, a leading name in the sports apparel industry, has sold over \$600 million in golf equipment on Woods's heels. Woods uses Nike clubs, dons the finest Nike clothing, including his trademark "Sunday Red" shirts, and made the Nike ONE golf ball famous in his chip-in shot on the 16th hole of the 2005 Mas-



ters tournament.

Other advertisers try to harness Woods's marketing prowess as well. According to Fortune Magazine, he made an estimated \$100 million in endorsements in 2007. Among his sponsors are AT&T, Gatorade, and TAG Heuer watches, each of which are leading names in their respective industries. Gatorade has even created a "Gatorade Tiger" brand, consisting of flavors and formulas "specifically designed to meet the needs of Tiger Woods." His return to competition will provide a much-needed infusion into these companies.

Woods entered the match play tournament against Australia's Brendan Jones on Wednesday. There was little evidence of a layoff for Tiger, who drove the ball as well as he ever has and seemed to have an improved short game. He beat Jones 3 and 2 through 16 holes, advancing to play South Africa's Tim Clark on Thursday.

Woods's second round did not go quite as smoothly, as he could not match Clark's six birdies through 16 holes. His play was technically sound, but the 33rd-ranked Clark admittedly played beyond expectations. "I knew I had to play out of my mind to beat him," Clark said. The South African took the match 4 and 2, eliminating Tiger earlier than expected. Given the severity of the injury he faced, he had little to be disappointed in regarding his performance. Following the tournament, he commented on the knee and his play.

"I was really pleased, walking down these cart paths and obviously playing and getting into the rhythm of playing," Woods said. "I have no soreness, have no pain. Now it's just a matter of getting back and playing, and playing more rounds."

The PGA and his sponsors are certainly hoping for more rounds.

A CITI-GOVERNMENT BANK *By Robert Sun, Carnegie Mellon University*

February came to a close with the Dow at its lowest since May 1997 and the S&P 500 at the lowest since December of 1996. Amid concerns about the health of the economy was the unsettling news to investors about Citigroup Inc. agreeing to turning over a significant stake of itself to the government. This sparked concerns about the prospects of the U.S. government taking large stakes in other debt-laden banks and wiping out stockholder value, and even to extremes of nationalization.

Twice, last fall, the government had come to Citigroup's rescue, infusing a total of \$45 billion into the company, as well as agreeing to protect Citigroup from most of the losses from its \$301 billion of assets.

Thus, it comes as no surprise that part of the deal involves an overhaul of the boardroom, with a majority of the executive board to be replaced with independent directors. The latest deal calls for a conversion of preferred shares to common stock and is expected to increase the Treasury's stake to around 40 percent of Citigroup. This helps to absorb some of the future losses at an above-market-value price of \$3.25.

Around Wall Street, some are calling the prolonged relationship between Citi and the government as a slow movement towards nationalization.

Said Neil Weinberg of Forbes Magazine, "what we've really had to date is sort of a slow, de facto nationalization where the government's ownership stake in Citigroup has over time, gotten greater and greater."

White House economic adviser Paul Volcker quickly tried to dispel rumors of nationalization at a congressional hearing on Thursday. Said Volcker, "I would not call that nationalization; I would call that capital restructuring."

However, while most investors are distraught at the mere possibility of nationalization, Weinberg actually believes that it might be the best option.

"Citigroup, Bank of America are names that come up prominently. Take them over completely, [and] get rid of the bad assets. Because what you have right now are zombie banks. They're neither dead nor alive, they can't really help the economy by lending aggressively and so you need to clean them up."



Weinberg might see it happen, as analysts predict that though the recent government rescue plan will help Citigroup, it won't help with the company's growing losses and may lead to more money in the coming months. Analysts project Citi to lose another \$1.24 billion in the first half of 2009.

Rather than boost confidence, the deal left investors' confidence wavering, with Citi's ratings cut from both Moody's Investors Service and Standard & Poors. In cutting its rating on Citigroup's debt to negative, Standard & Poors believed that even bondholders may be affected.

"Debt holders could eventually be required to participate in further government-led restructuring actions," S&P said.

In brighter news, the deal will have no effect on the Citigroup's 20-year, \$400-million naming rights deal with the Mets for Citi Field.

THE STRESS TESTS: TIER I CAPITAL VS. TCE *By Jordan Cole, Arizona State University*

Greenhorn Treasury Secretary, Tim Geitner, announced a rudimentary plan to save the financial system last week. He outlined the Treasury's plan to administer a stress test measuring a bank's solvency in the event of economic catastrophe before it may receive more taxpayer generated government assistance. Injected government funds would be in the form of mandatory convertible preferred shares. The preferred shares would only be converted to common equity as losses occur.

It is not the government's goal to nationalize the banks and wipe out existing shareholders. Rather the treasury maintains that the capital is only a temporary remedy to ensure the continuity of lending. According to President Obama in his address to Congress, the only way out of the recession is to restart lending to fund businesses and home owners.

The goal of the stress test is to determine how much more capital the banks would require should the recession deepen. Federal Reserve regulators previously required Tier 1 capital to be at least 6% of total assets. Regulators are presumed by many on Wall Street to be analyzing the balance sheets of banks testing that each can weather a deeper recession if unemployment were to rise to 12% and home prices declined by another 20%. It is presumed that many banks will require more capital as a result of the analysis.

A new metric used on Wall Street and being adopted by the Fed to monitor the banks liquidity to common shareholders is known as tangible common equity or TCE. The TCE ratio has replaced the more commonly used Tier 1 capital ratio as the acid test to assess the health of the financial sector's balance sheets due to the potential massive dilution effects of the government's stake in the financial institutions.



The ratio calculates the payoff a common equity shareholder would receive in the event of liquidation. It is found by dividing common equity by the tangible assets.

Inherent in this ratio are three key assumptions. TCE does not differentiate between safe and risky assets.

The aforementioned Tier 1 capital compared a firm's equity capital to its total risk-weighted assets. Risk-weighting is performed by weighting the credit risk of each of assets listed on the firm's books. The key differentiator between the two ratios is the consideration of risk.

TCE also ignores intangible assets such as goodwill, deferred taxes, and mortgage servicing fees, the theory being that in downturns these assets are less likely to have value. Lastly, it classifies preferred shares as debt rather than equity.

In an effort to boost confidence in the market, the government hinted at the possibility of its preferred shares being converted into common shares, a move that would boost TCE ratios. The TCE ratio is a more conservative metric than the Tier 1 approach and demonstrates the lack of confidence investors have both in the regulators and the companies themselves.

The benefit of converting the government's preferred shares into common ones is two-fold. It will boost the bank's tangible common equity ratio while also boosting investor confidence in the process.

Partnering with the government as a common shareholder would not be a negative. Its backing in the same equity class would guarantee the other common capital shares as the institution would never be allowed to fail.

JAPAN'S ZOMBIE BANKS OF THE 1990S *By Kishore Ramaswamy, Carnegie Mellon University*

he concept of 'zombie banks' first arose during Japan's banking crisis of the early 1990s. These were financial institutions that continued to receive aid from the Japanese government despite their inability to produce profits. The bursting of the Japanese real estate bubble, which lasted from 1986 to 1990, led to a prolonged economic crisis, in which there was widespread deflation, failure of numerous banks, and in turn, the crumbling of the financial system. Instead of giving up on failed banks, the government rather invested almost 12% of the country's GDP in trying to salvage the unprofitable financial institutions. This long period of economic stagnation during the 1990s came to be known as Japan's 'lost decade.'

Studies have shown that the rise of zombie banks had actually "depressed investment and employment growth of non-zombies and widened the productivity gap between zombies and non-zombies," according to Anil Kashyap, an economist from the University of Chicago.

By living off of government aid, the zombies would erode away the normal competitive environment by preventing even the healthier banks from gaining market share and boosting investment. This in turn had adverse effects on the overall economy by lowering productivity and significantly increasing inefficiencies in the market.

Kashyap, Hoshi, and Caballero were three economists who studied the effects of zombie firms on the Japanese economy. They came to the conclusion that zombie banks (and firms) also led to the destruction of creativity in the economy. Kashyap claimed that, "Under normal conditions, zombie firms would have gone bankrupt and been replaced by new and better business ideas and models.

Usually when an industry is hit by a bad shock, many firms exit. In Japan, firms never exited. Given that they never exited, it is not surprising that new firms weren't created." In addition, it makes it very difficult for new companies to enter the market because they have to overcome the subsidies that are given to bankrupt firms, thereby leading to high operating costs, and in turn, high barriers to entry.

This illustrates the dire consequences of poor regulation (or lack thereof) of the banking industry and of continuing to hang onto zombie banks and firms. The percentage of zombie firms in Japan lingered at roughly 10-15% until 1993, and then rose sharply to over 25% of total firms in the mid to late 1990s.



Although the rise of zombie banks reduced the impact of an economic downturn (as opposed to letting the banks go bankrupt) in the short run, in the long run however, this temporary advantage was eroded by the lack of job creation, decrease in productivity, market inefficiency, and severe economic stagnation.

So is it worth digging up the corpses of insolvent banks from their graves? President Barack Obama has drawn

parallels between the current U.S. economic situation and Japan's period of economic stagnation during the 1990s, stating that a failure to take bold action could lead to another 'lost decade.' AIG, Citigroup, and Bank of America are the most prominent names that top the list of zombie banks in the United States.

They continue to survive by devouring taxpayer money, despite their failure to produce profits. If we continue along the same path, we would be following in the undesirable footsteps of Japan during the 1990s.

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