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Who Created the Financial Crisis and How Do We Prevent the Next One?

All parties are nominating scapegoats. Free-marketers say that government pushed agencies and originators to give mortgages to the non-creditworthy and kept interest rates too low for too long. Liberals counter that regulation was inadequate and oversight was lax. Congress and much of the public blame greedy bankers, redecorating their offices with \$15,000 commodes while the system tanked.

The greed theory is clearly irrelevant. Wall Street has always had greedy people, as indeed has Congress. Interest rates have gone up and down in real and in nominal terms, and governments have favored various constituencies since governments were invented without automatically triggering a global financial crisis.

Moreover, pretty much everyone involved in the current crisis – the bankers, the regulators, members of the Congress and the executive branch – were and are intelligent, highly educated people. Venal or not, they certainly didn't intend to promote a disaster. The titans of Wall Street were heavily invested in their own stock and lost staggering fortunes. Tens of thousands of lesser lights have lost their jobs and most of their savings.

We have experienced the failure of a system, not failures by specific people. To fix things we need to change the system not just the people. Luckily, while the needed changes are fundamental, they are, at root, quite simple. We need to reform the *structures* of the participating companies and of the legal and regulatory processes within which they work. We must change the *incentives* both of the employees of the companies and of their regulatory overseers.

Business structure

The financial corporations that led our debacle are very large, typically multinational but always multi-business-line investment and commercial banks. All the key entities are common-stock companies owned

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by a variety of institutional and individual shareholders. There are two key problems with this.

Vast, complex, publicly traded financial businesses cannot work.

No top management team can understand and effectively manage its full spectrum of activity and risk-taking: corporate finance advice, underwriting and distribution of complex securities, asset management, credit-card lending, mortgage banking, property and casualty insurance, life insurance and more. Who can understand how these interact when the institution is exposed to a business cycle? We have been here before – many times – but on a smaller scale. For example, Barings Bank fell victim to Nick Leeson's fraud because its management of corporate financiers didn't realize that the supposed arbitrage-based earnings of its equities department were implausibly large.

Because management can't understand enough personally, they rely on mathematical risk models. But of course the modelers can no more comprehend the breadth of risk than can the management. They try to infer the nature of credit risk from statistical series on losses and recoveries, but records are made to be broken, in finance as in sport. Recent "extreme" events have been large enough to wipe out the profits of a decade or two of apparently successful speculative dealing.

Public company accounting produces equally worthless numbers. Accountants report quarterly and annual results. Yet the business cycle, sadly, runs on its own schedule. This is the meaning of the infamous remark by former Citigroup CEO Chuck Prince that you have to dance as long as the music is playing. Had a bank pulled in its horns, it would have shown poor calendar measures of performance, its management would have been replaced, and its best employees would have jumped ship to other entities still willing to gamble. Regulators also prefer the calendar to the economic cycle when they assess the adequacy of loss reserves and capital.

Entities in which groups of professionals make complex decisions with implications not evident for years are not well suited to public ownership.

Investment banks, asset management firms and private equity and venture firms used to be run by private partnerships, as indeed were commercial banks in an earlier era. Partners who bore the long-term risks of their decisions were famously prudent with their capital and their compensation, not least to non-partners.

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This prudential ownership structure ended when it became advantageous to deploy large amounts of capital to expand inventory holding of securities, to support proprietary trading, and to bridge and otherwise facilitate merger

transactions. The profits from advice were leveraged with the equity of others, and the return on the equity as a whole was leveraged with the debt of others.

Deploying capital in this way creates moral hazard because of the one-way nature of the bet. A good gamble creates fortunes. In a bad one, well, jobs are lost but mainly the money of others is lost. It also creates systemic risk because entities bloated to enormous size on leverage become too important to the credit processes of the economy to be allowed to fail.

Regulatory structure

Look past the escalating calls for more and better regulation to recognize that financial services are already one of the most regulated industries in the world. Regulators are limited in effectiveness because they have the same problems of the top management of a banking conglomerate while being several steps further removed.

The regulators can no more understand the full risks and opportunities of a Citi than can the management. One regulator handles broker/dealers, another commercial banks, another insurance, and so on. Separate, they struggle over regulatory turf; together in some super-agency, they would be in a somewhat

worse position than those people in Citi's board room who couldn't see the hurricane that was about to hit them.

Their situation is made worse by lack of money. They can afford neither the brilliant fat-cats sitting in the investment banks nor their analytical data and tools. Today's mood is to pay bankers less than the president, not to pay the bureaucrats as much as the brokers.

Business incentives

Combining calendar-year success-based compensation in public companies with the long-tailed consequences of business actions has unfortunate consequences.

Business choices in these complex entities are very difficult to evaluate from the outside. Investors, counterparties and regulators must rely on the top management to make all key decisions, not least the design and operation of the incentive system.

Once outside the private partnership world, the equilibrium state of the incentive system will be permanently unfavorable to stability. Incentives with long lock-ups will fail because another firm will offer a shorter lock-up for the "best performers," another one will counter, and so on. That is why, in the middle of the greatest collapse of equity values in decades, successful stockbrokers are being promised multi-year guaranteed compensation if they move to a competitor. Subject the whole industry to pressure to limit compensation and new industries are created, like private equity and hedge funds.

Regulatory incentives

Here we need to acknowledge some unpleasant realities.

Regulators are never thanked for the things that don't go wrong, but if a problem arises the search for the guilty starts with them. There is a strong incentive for regulators to resist all change in case it creates unanticipated problems and thereby slows down all progress.

And these are the accusations hurled at all regulators by the regulated. The consequence is to discredit the regulators in the eyes of public and government in those long quiet periods when they seem to be nothing but an obstacle. Then the big broker/dealers can convince Congress to increase their leverage from 12 to 30 because it will facilitate some grand public purpose like underwriting more mortgage securities.

Regulators are as ambitious as the rest of us. Work as an SEC attorney for a while and you are likely to be hired by a big Wall Street firm to handle its regulatory relations. Thinking ahead, as ambitious and capable people do, it would be best not to excessively alienate your future employers.

What we can do about it

While these realities are deeply entwined in our economic and political system, there are completely feasible steps we can take that will materially lower the risk of our financial system. We need to simplify and limit the size of the players; cap leverage; and, to the extent possible, take the key risk-taking entities out of public ownership and back to private partnerships.

Cap size. There may be economies of scale in production and "one-stop" convenience for customers. However, the diseconomies of complexity and systemic risk clearly outweigh these benefits. First, we need to break up multi-industry businesses along the lines of Glass-Steagall. Then, of equal importance, we need to cap market share by line of business in order to keep the players below "systemic-risk" size.

Cap leverage. However bad an idea is, leverage makes it worse because it makes it bigger. We can go a long way to enhancing stability if we simply limit explicit leverage allowed to the now-smaller and more focused financial market players that we would create.

Return the risk-taking to ownership by partners. Only partners have the long-term incentive to create thoughtful approaches to risk-taking while being close

Return the risk-taking to ownership by partners, who have the long-term incentive to create thoughtful approaches to risk-taking while being close enough to the risks to understand them.

enough to the risks to understand them. Not all financial businesses can be partnerships. But we can try to reinstate mutual ownership of exchanges and private ownership of all entities entitled to provide opinion letters on valuations or due diligence on underwritings. We can try to do the same with ownership of rating agencies. We should explore introducing these “incentive blockers” in as many places as we can.

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Eyes Abroad

This column will be a regular feature in our newsletter, discussing different aspects of our interconnected world.

The world is smaller today than it was yesterday, and now more than ever political events and developments abroad – whether in Beijing, Brussels, Budapest or Brunei – have the potential to affect you financially. With this ongoing column, I hope to share my observations and insights regarding select international political developments that are both interesting and of potential financial import.

In such an interconnected global environment, it is all but impossible to avoid the effects of international political developments (let’s call them “IPoDs” for short). This is particularly true with respect to investments. Even investment strategies thought to be mostly domestic in nature can be affected, but the effects are most pronounced in diversified portfolios with international or global exposures.

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Most US-based financial advisors concern themselves, principally, with monitoring news of developments here at home with an eye toward understanding and explaining their impact on domestic markets. We do

that too, but we also recognize the interconnectedness of markets and economies and, therefore, think it our obligation to monitor changes abroad – including IPoDs.

Of course, resources expended analyzing IPoDs are justified only if we employ an investment process that, when appropriate, affords us the ability to reflect our conclusions in client portfolios. Not all advisors do – firms

differ significantly in how (or whether) they manage allocations in light of changing market conditions and expectations. In this respect, advisors generally fall into one of three groups:

One group doesn’t change portfolio allocations once created. In other words, the strategy remains more or less static except for periodic rebalancings to take portfolios back to the original asset allocation. This group resides at one end of the spectrum.

The second group is composed of market timers. They reside at the opposite end of the spectrum and typically have two gears: they’re either invested or they’re in cash. When markets are expected to go up, they invest. When markets are expected to go down, they go to cash. From a client’s perspective, the notion that he or she will be invested only when markets are going up is, of course, immensely appealing. The problem, however, is that market timing just doesn’t work (for more just Google “Bill Sharpe” and “market timing”).

We fall into a different camp. Unlike the static allocator who puts client portfolios on cruise control, so to speak, we make the effort to understand what’s really going on in the world and, when appropriate, adjust our strategies to reflect these views. However, unlike the market timer who takes “all in” or “all out” bets, we formulate reasoned views about larger identifiable trends and expectations (including IPoDs), then we “shade” specific investment exposures to reflect those views.

Although there are myriad important IPODs worthy of discussion, particularly now, it seemed more appropriate in this inaugural column to explain the relevance of IPODs to you and to our investment management process. In future columns, however, we'll move on to the more substantive task of sharing observations and analysis on select developments abroad that are both interesting and of potential economic import to us all.

About the author: David Magee, Contango's president, was an executive director and head of private banking with UBS, a principal at Montgomery Securities, and a capital markets specialist at Oppenheimer before founding his own firm, Panoptic Solutions, Inc. He holds a BA in international affairs from George Washington University, an MA in international journalism from Baylor University and a JD from Tulane Law School.

Time to Sell Your Business? Plan Ahead for the Long Journey

Featured in the September/October 2008 issue of Zions Bank's Community magazine.

There comes a time in nearly every business owner's life when the question must be faced: Is it time to sell the business and move on?

You can prepare for that question long before it's time to answer it. Even if you have been postponing a decision because of the current economic situation, let us explain why you should start preparing. By planning ahead, you are more likely to have a better understanding of your options and how each one might affect your personal and financial goals.

If you're in your 40s or beyond, it's not too early to start thinking about how you'd approach a sale. And if you *know* you'll want to transition your business in the next five years, now is the time to put the planning wheels in motion.

Step 1: Sketching the big picture

Business sales are complex. Before you set out, you should have a sense of where you want to go. Will you retire? Start another business or career?

You'll need to calculate the price of those dreams. What price can you realistically get for your business? Can you do anything to add value before the sale? What are the transition alternatives?

Step 2: Staging the business for sale

If you've ever sold a residence, you probably improved and "staged" the home to make it more appealing. Selling a business is the same: You need to "tidy up" to attract a good buyer. But the business equivalent of new paint and carpet is a bit more involved.

Buyers are going to look at both your intangible and tangible assets, so you need to evaluate how you look on paper. For instance, if you're operating as a pass-through entity and not showing a profit, you might consider restructuring.

Buyers will also look at your business operations. The more capacity there is to leverage operations, market position or finances, the more attractive the business will be to a buyer. So, now might be the time to look at your growth plan.

Buyers will assess the business's viability without your ongoing involvement. A robust management succession plan should support the business's value.

Step 3: Accounting for emotion

Even in the most harmonious families, serious conflicts can arise around the sale of a business. Add in the competing interests of employees, community, partners and your own personal goals, and emotions can run very high.

A well-conceived plan can address family and estate issues. It can also help you implement key employee incentives that can make your transition much smoother for everyone involved.

To catch up on any of our client calls, go to the Contango website, www.contangocapitaladvisors.com, and click on the link for the call you'd like to hear.

Step 4: Protecting your assets

If you're like most middle-market business owners, you may have a significant portion of your wealth tied up in your business. That's why it's so important to look comprehensively at the financial impacts of the sale. At every stage, there are opportunities to protect your assets and increase their value – everything from putting a price on the business, structuring the transaction, and creating a wealth management strategy for the years after the sale.

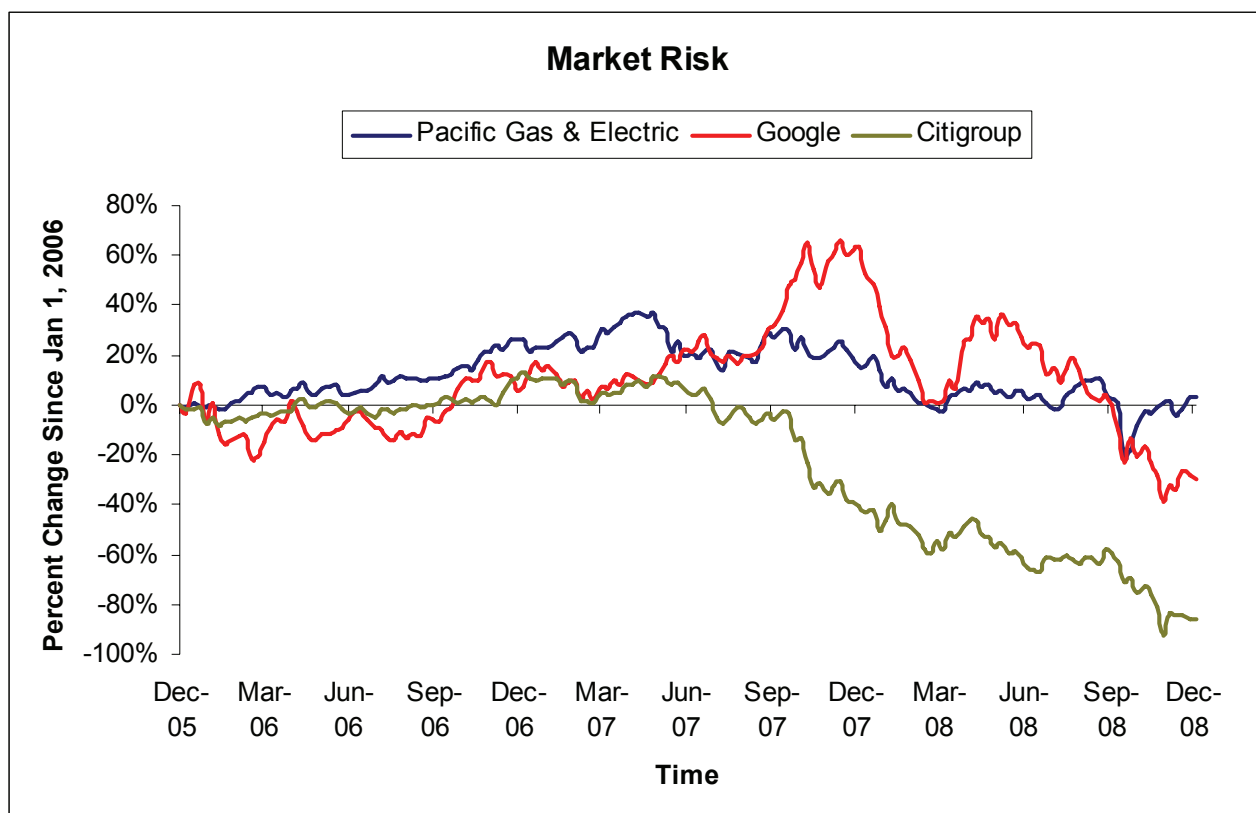
Selling is a big decision, but with a good plan, the road to your next adventure in life is just ahead.

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Spotlight on Market Risk and Volatility

Market risk is a chance that an investor takes. No matter what the long-term prospects of an investment or its probable intrinsic value, an asset may trade at any price in the market. A trading price is determined by the interactions of buyers and sellers. If there is more buying than selling of an asset, its price will rise; if there is more selling than buying, its price will fall. This means that an investment's price can rise, fall and bounce around. The extent of these movements is usually described by the term *volatility*.

We describe Pacific Gas and Electric Company's stock as having low volatility because it has relatively small price fluctuations, whereas a highly volatile investment like Google stock will be subject to relatively larger price swings. Because the extent and timing of these bounces is unpredictable, the possibility exists that any asset could trade for a price that is lower



Source: Bloomberg

than you might rationally expect. For investors, these bounces can be a source of concern when they create unrealized losses in a portfolio.

The real risk to investors, however, is that they might need to sell an asset at a relatively low price, thus turning an unrealized loss into a realized one. Also, investors may be forced to write off an asset if it loses its entire market value (traded value equals zero).

Nobody can predict the future. Therefore, we can only estimate when and by how much market sentiment might reverse itself, which types of assets might recover, and which become permanently impaired, as perhaps Citigroup could be. Because investors demand compensation for this risk, a portfolio of more volatile assets will often produce higher long-term gains than a portfolio of less volatile ones, but not always.

We mitigate volatility by diversifying. Because we do not expect all assets to move up and down in lock-step, we smooth out portfolio returns by investing in a broad range of assets. Diversification allows us to balance the ups with the downs and to limit the impact of any asset going to zero. We do not put all our eggs in one basket lest the basket turns out to resemble Citigroup at the end of 2008.

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IMPORTANT NOTES

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