Reflections and Outrage

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Good morning.

I want to thank Morningstar for this honor of speaking to you today. We go back a long time, beginning in 1986, when Don Phillips became the very first analyst to cover my two funds, FPA Capital and FPA New Income. I am deeply grateful for having been selected three times for the Morningstar Manager of the Year award and being recognized for my work in both equity and fixed income management.

For those of you who do not know, I will be taking a sabbatical beginning next year. My trusted partners, Dennis Bryan and Rikard Ekstrand will assume leadership of FPA Capital Fund while Tom Atteberry will do the same for FPA New Income. These three outstanding managers are here today should any of you wish to meet and speak with them. Having a high degree of confidence in them as well as FPA, I will be leaving all my personal investments in the various funds and will retain my equity ownership in the firm. Many executives say they have confidence in their associates but few demonstrate this in such a tangible way. I will return 2011 in a supporting role. My decision to take a sabbatical has nothing to do with the current tumultuous market or my health. More than six years ago, I discussed this as a possibility. I consider this step part of the process of succession planning and execution.

This will complete my 39th year in the investment business, 35 of these being as a money manager and analyst, with 25 at FPA. It has been a wonderful experience, though a humbling one at times. I believe I have found success because I have been deeply aware of the need to balance the human emotions of greed and fear. In a word, DISCIPLINE. As a board member on the University of Southern California's Student Investment Fund program, I tell our students that discipline is a key attribute to becoming a successful investor. I stress that, without a strong set of fundamental rules and a core philosophy, they will be sailing a course through the treacherous investment seas without a compass or a rudder. I also emphasize the importance of integrity and tell them that they can spend a lifetime building their reputation and, if they are not vigilant, they can lose it in a day.

I have always maintained my professional and personal integrity. I have never wavered, despite having paid some very high prices. It seems as though it was a lifetime ago in 1986, when I had few assets under management, and the consultant to my largest account insisted that, if I wanted to continue the relationship, I had to pay to play. I was shocked, dismayed and speechless. Though this would probably have never become public, if I had agreed, how would I have ever lived with myself? By not agreeing, it meant that I would lose nearly 40% of my business. When I was fired shortly thereafter, this termination compromised my efforts in the raising of new money for nearly six years because I could not say why. Despite the pain and humiliation, there was no price high enough for me to compromise my integrity. With the subsequent disclosures of improprieties at this municipal pension plan, the cloud of suspicion over me ultimately lifted. I not only survived, I prospered.

I relay this short story because it conveys some beliefs that will run throughout my speech today entitled, "Reflections and Outrage." I will make some comments and observations about our industry, the government and then provide a brief financial market forecast. These are my honest opinions for better or worse.

The Mutual Fund Industry

Let's be frank about last year's performance, it was a terrible one for the market averages as well as for mutual fund active portfolio managers. It did not matter the style, asset class or geographic region. In a word, we stunk. We managers did not deliver the goods and we must explain why. In upcoming shareholder letters, will this failure be chalked up to bad luck, an inability to identify a changing governmental environment or to some other excuse? We owe our shareholders more than simple platitudes, if we expect to regain their confidence.

Diversification effectively failed as a strategy. All asset classes, other than cash, gold or Treasury securities, lost money. If Morningstar will allow me a small transgression by quoting Lipper Research, "Equity funds posted their worst one-year return in Lipper's 49-year-old database." It didn't matter whether they were U.S. diversified equity funds or world equity funds with declines of 37.5% and 45.8%, respectively--so much for decoupling. This is a concept we never subscribed to at FPA.

For the record, my own fund, FPA Capital, was not a stellar performer either. It was down 34.8%, although it did outperform the average diversified domestic equity fund and mid-cap value fund. In my latest shareholder letter, I discuss the reasons for this lousy performance and attempt to explain why I believe it is only temporary versus other types of performance declines that appear to be more permanent.

The same criticism can be leveled at fixed income managers as well, since domestic and world income funds lost money last year. Only Treasury and GNMA bond funds provided positive returns. Our bond fund, FPA New Income, however, did perform extremely well by achieving a positive total return, our 25th year in a row during our management, and its widest performance differential versus its peers.

Did the industry try and prepare for this tsunami of a credit debacle? I don't think so. Whether in stocks or in bonds, it seems as though the same old strategies were followed--be fully invested for fear of underperforming and don't diverge from your benchmark too far and risk index tracking error. The industry drove into this credit debacle at full speed. If active managers maintain this course, I fear the long-term outlook for their funds, as well as their employment, will be at high risk. If they do not reflect upon what they have done wrong in this cycle and attempt to correct their errors, why should their investors expect a different outcome the next time?

Investors have long memories, especially when they lose money. As an example, prior to FPA's acquisition of FPA Capital Fund in July 1984, the predecessor fund was a poster child for bad performance from the 1960s era. Each time the Fund hit a $10 NAV, it would get a raft of redemptions since this was its original issue price and investors thought they were now finally even and just wanted out. This trend eventually stopped in late 1987, twenty years after the Fund's founding. I believe investors will react in a similar fashion after this market collapse.

During the 1998-2000 performance derby races, a head long rush into speculation took place when growth stock "investment" managers chased Monopoly money-like stocks called "dot com" and other types of technology stocks. The fear of being left behind by not owning them was quite evident and I was utterly shocked and dismayed by their capricious actions. Where was their discipline? What were they thinking and did they ever consider how they might destroy their client's capital? At the time, I referred to dot com company valuations as, "not only discounting the future but also the hereafter." Did these managers learn anything and have they reflected upon what went wrong and how they would change their investment management for the better? The academic community wrote very little on this period but an original thinker and my late friend, Louis Lowenstein, did so in his paper, "Searching for Rational Investors in a Perfect Storm." I recommend it. Why should individual investors and others trust managers who threw investment caution to the wind? This type of recklessness undermines the basic justification for active investment management versus simply being invested in Index funds.

While technology stock and growth stock investing hysteria were running wild, we did not participate in this madness. Instead, we sold most of our technology stocks. Our "reward" for this discipline was to watch FPA Capital Fund's assets decline from over $700 million to just above $300 million, through net redemptions, while not losing any money for this period. We were willing to pay this price of asset outflow because we knew that, no matter what, our investment discipline would eventually be recognized. With our reputation intact, we then had a solid foundation on which we could rebuild our business. This cannot be said for many growth managers, or firms, who violated their clients' trust.

We also did not run with the herd in 2005 and 2006, and thus, FPA New Income's assets declined from $2.1 billion to $1.6 billion. This process began in 2003 when we deployed an extremely defensive portfolio strategy whereby we would no longer buy any intermediate or long-term Treasury bonds because, in our opinion, they were devoid of any investment merit. We considered the monetary policy being implemented by former Federal Reserve Chairman Alan Greenspan to be insane and that it would create another bubble. Little did we know how big it would become. Because of the low yield environment, new types of securities were created to meet the demand for an enhanced yield. We did not chase yield by purchasing these highly complex, purported to be high-quality, securitized alphabet soup labeled securities created by propeller heads. Reaching for yield, in a low yield environment or because of competition, always leads to disaster, as reflected by the carnage in so many bond and money market funds last year.

It would be unfair of me to level criticism just at growth managers. Many value managers have a lot of explaining to do as well, given last year's poor performance, driven largely by an overweighting in financial stocks. How did they miss the greatest credit excess in the modern era? How could we have a pandemic breakdown in loan underwriting standards and so many managers miss it? What were they doing in their research? After the collapse of Bear Stearns, I reviewed the changes in portfolio holdings of many value managers and saw additions to their holdings in Fannie Mae, Freddie Mac, AIG, and Washington Mutual, to name a few. What were they thinking?

In contrast to these actions, our firm expressed the view, in our March 30, 2008, website commentary, "Crossing the Rubicon," that we had crossed over into a new financial system and new era that required great caution since a new set of economic ground rules was being created and the shape of the playing field could not yet be determined. Because of the changed nature of our financial system, we felt that a significantly higher hurdle rate had become necessary for most financial stock and bond investments. For the industry in general, rather than demonstrating caution, it seemed as though each week another "expert" was calling for a bottom in financial stocks. If portfolio managers and analysts cannot recognize the greatest credit blow-off in the last 80 years, when will they? What new procedures and policies have they implemented at their firms to address this new environment and protect them from making similar mistakes in the future? I believe these are questions that must be answered in order to regain and retain investor trust.

I am not without shame. I wrote about my worst investment failure, Conseco, in FPA's first website commentary in 2002. My failure was in not recognizing the breakdown in its underwriting standards that led to lending excesses. I analyzed what critical variables I had missed and discussed my errors openly in my shareholder letters and other public communications. Both Tom Atteberry and I served on the creditor's committee rather than take the easier road by saying, "It's a loss and a waste of time, so let's move on to the next investment." Out of this bankruptcy, we developed a template that could be applied to the credit excesses that were to come later, but on a far wider scale. By being totally open about my failure, I believe it has enhanced my personal credibility.

Having the courage to be different comes at a steep price, but I believe it can result in deep satisfaction and personal reward. As an example, FPA Capital Fund has experienced heavy net redemptions since the beginning of 2007, totaling more than $770 million on a base of $2.1 billion. My strong conviction that an elevated level of liquidity was necessary, at one point reaching 45%, placed me at odds with many of our shareholders. I estimate that approximately 60% left because of this strategy. One relationship withdrew $300 million because my policy upset their asset allocation model. We have been penalized for taking precautionary measures leading up to and during a period of extraordinary risk. Though frustrating, in our hearts, we know that our long-term investment focus serves our clients well. I believe the words of John Maynard Keynes as expressed in his book The General Theory of Employment, Interest and Money (1936), are reflective of our investment style. He said, "Investment based on genuine long-term expectations is so difficult today as to be scarcely practicable," and "It is the long-term investor, he who most promotes the public interest, who will in practice come in for the most criticism wherever investment funds are managed by committees or boards or banks. For it is the essence of his behaviour that he should be eccentric, unconventional, and rash in the eyes of average opinion."

We are again running contrary to the consensus, shifting course in our equity investment strategy in a way many would consider to be high risk. We deployed more capital than at any other period in the last 25 years, late last year and early this year, with 67% directed into energy stocks. This added to FPA Capital Fund's hefty energy exposure that existed prior to the market collapse. Over 50% of the Fund's equity investments are currently in energy. You may read more about our rationale in the March shareholder letter. We have skewed our research toward companies that will benefit from what I believe to be the beginning of a "New World Order." In my opinion, the old economic order began at the end of WW2 and ended in 2007. Mercantilist nations in Europe, Asia and other parts of the world operated with the strategy of having a cheap currency that made their exported goods attractively priced for a financially sound and unleveraged American consumer. With the recent collapse of the American consumer's over-leveraged balance sheet, a new era has begun. Foreign countries will have to restructure their economies to emphasize domestic growth so as to offset the structural reduction of

U.S. demand for their exports. China has already begun this process. If my outlook is correct, many sectors of the U.S. economy will be negatively affected. Active managers will have to make some hard choices as to how they deploy capital going forward.

I believe superior long-term performance is a function of a manager's willingness to accept periods of short-term underperformance. This requires the fortitude and willingness to allow one's business to shrink while deploying an unpopular strategy. Additionally, in the low return changing world I foresee, a well diversified mutual fund of U.S. stocks will likely have a harder time outperforming the stock averages and index funds, as a result of its higher expense ratio. A more focused strategy will be necessary to excel. If active managers continue to adhere to their old practices, we should see a contraction in the active mutual fund management universe over the next five to ten years. First Pacific Advisors plans to be among the survivors.

Government and the Credit Crisis

What a mess we are in. There is little question that this is the worst economic contraction since the Great Depression. It is worse than a recession but not as bad as the Depression. I have a new word for it, "repression." From its beginning, I have been of the opinion that this is not a normal recession and that the economy would not respond to typical economic policy stimuli. This idea was expressed in my September 2007 shareholder report.

I wonder why so much credibility is bestowed upon many of our government officials. Former Federal Reserve Chairman Greenspan expressed on several occasions that a bubble could not be recognized before it occurred. In his remarks before the Office of the Comptroller of the Currency in 1999, he said, "Collapsing confidence is generally described as a bursting bubble, an event incontrovertibly evident only in retrospect." [1] Apparently, he couldn't recognize the internet bubble, but when it popped, he attempted to stabilize the economy from its negative effects by implementing a misguided and unsound monetary policy that instead initiated the greatest credit and asset bubbles since the Depression. While Alan Greenspan was in Shanghai in May 2007, the BBC News reported that he said the Chinese stock markets had risen to levels that were "unsustainable" and that they were overvalued. [2] Then, while he was in London in October of that same year, Reuters reported he said, in response to a question about the Shanghai stock market, "If you ever wanted to get a definition of a bubble in the works, that's it." [3] How is it that, as the Fed Chairman, he cannot recognize a bubble in the U.S., but as a private citizen, he can travel more than 6,000 miles from Washington and recognize one in a foreign country?

Chairman Bernanke also has his difficulties recognizing bubbles. In a June 2004 interview with The Federal Reserve Bank of Minneapolis, not yet Federal Reserve Chairman Bernanke said, “I think it’s extraordinarily difficult for the central bank to know in advance or even after the fact whether or not there’s been a bubble in an asset price.” [4] While in October 2005, according to The Washington Post, Mr. Bernanke “does not think the national housing boom is a bubble that is about to burst.” [5] I guess the housing bubble was just too small for the Fed to recognize.

It appears that neither of these Fed Chairmen could recognize the two greatest U.S. bubbles in the last 80 years. In contrast, at FPA, we identified excesses in Alt-A securities back in the summer of 2005 and extended that analysis into subprime and other sections of the credit market. I asked a major savings and loan CEO why he thought we were seeing unexpected deterioration in our Alt-A mortgage pools that was materially different from our experience of the last two decades. His response was, “Fraud.” Upon further investigation, we concluded there was a widespread breakdown in underwriting standards and that this was leading to a blow off in the real estate market as well as other segments of the U.S. economy. In contrast, Fed Chairman Bernanke, in both April and June of 2007, said that there would be no contagion from the subprime credit debacle. Not to be outdone, former Treasury Secretary Paulson affirmed this view in August while on a trip to China. This is not Monday morning quarterbacking on my part since these conclusions were detailed in my shareholder letters as well as in my June 2007 speech, “Absence of Fear,” that I gave here in Chicago to the local chapter of the CFA Society. At FPA, we also wrote extensively on the growing bubble in the stock market in 1999 and 2000 and said that valuations were far in excess of those that preceded the 1929 crash.

Why am I detailing these errors in analysis or judgment? It is because of the extraordinary actions and policies that have been implemented by the Fed, Treasury, the Congress and the Executive branch to address this credit and economic crisis. Let me make my viewpoint perfectly clear, my trust has been severely shaken in the Federal Reserve, the Treasury, the Congress and the Executive branch of government in their collective judgment as to what is required and appropriate for a fundamentally sound long-term economic recovery. Incorrect analysis, obfuscation and political posturing have brought me to this realization. Since the beginning of this credit crisis, both the Fed and Treasury have assumed that a collapse in available liquidity was its cause. At FPA, we concluded it was a capital destruction crisis and that the supply curve of credit in the U.S. had shifted to the left with the demise of the structured-finance market. We also believed that overly optimistic business plans for both depository and non-depository financial institutions had further compromised their balance sheets. Many of these institutions were acting like hedge funds, in disguise, as my associate, Steven Romick, so eloquently detailed in his December 31, 2006 FPA Crescent Fund shareholder letter.

The regulatory agencies and the federal government were complicit in laying the groundwork that allowed many of these credit excesses to develop prior to this economic crisis. Had they done their job effectively, the economy would not have been pushed to the brink of collapse. The “too big to fail” doctrine, that was allowed to develop over the years, reduced the number of viable regulatory options available to deal with this crisis. Given this history of laxity, I am dubious of the federal government’s ability to properly identify and prescribe the appropriate economic and regulatory responses. As we noted in our July 30, 2008 website commentary, “Disgusted and Betrayed,” “It was only on July 10th 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.’” On September 7, 2008, the Federal Housing Finance Agency announced the decision to place both of these institutions into a conservatorship that resulted in the debt and mortgage-backed securities being effectively guaranteed by the U.S. government. The Office of Management and Budget now projects that they will need an additional $92.2 billion by September 30 and this is supplementary to the $78.8 billion already received. Both companies have an emergency capital commitment from the Treasury for $200 billion each. For years we were told these agencies were private companies with only limited access to the Federal government’s balance sheet. We clearly must exercise extreme caution and skepticism when listening to our government officials.

At FPA, we fundamentally disagree with these “rescue” programs since we believe our impaired financial system is being distorted by protecting inefficient and questionable business enterprises. These programs reflect a philosophy of DWIT—Do Whatever It Takes—to stabilize the economy now. Maybe I should call it DimWit? In my opinion, a perfect example of unwise policy has been the economic support of the automotive industry, especially GMAC. At the end of last year, the U.S. Treasury invested $5 billion in GMAC senior preferred equity with an 8% yield. These new funds allowed the company to resume auto lending to support the sale of GM cars. With an 8% cost of capital, new loans were made with rates as low as zero percent. FICO scores were also lowered from 700 to 621, just one point above what would be considered a sub-prime loan. Aggressive lending practices like these are what got GMAC into this mess in the first place. This illustrates how a policy that is meant to help may actually have an unintended consequence that undermines the competitive capability of a more prudent lending institution.

Misguided measures to re-stimulate consumer borrowing, beyond just getting the system functioning, are highly questionable. The combined collapses of stocks and housing prices have pummeled the U.S. household’s net worth by an estimated $12.7 trillion, according to the Federal Reserve, while ISI International estimates it to be in the area of $14 trillion. This net worth destruction is the most severe since the Great Depression. We have a news flash for the government, creating new credit programs for a consumer who was spending almost $1.1 trillion more than they were earning in spendable income, according to MacroMaven’s estimate, will be a non-starter. More leverage is not what they need.

Encouraging the consumer to take on more debt is like trying to help a recovering heroin addict lessen his pain by providing him with more heroin.

A dramatic rise in the U.S. personal savings rate will be required to begin the mending process of the consumer's balance sheet. I expect the U.S. personal savings rate will rise from 2% to 8% this year and remain at an elevated level for the foreseeable future. This process should increase savings by approximately $650 billion annually. An increase of this magnitude, in such a brief period, is unprecedented, other than during WW2, when it rose from 12% to 24% between 1941 and 1942. Assuming some earnings on this incremental savings and a partial recovery in the stock and real-estate markets, it will likely take ten years for the consumer's net worth to return to its pre-crisis level.

Governmental programs deployed to stabilize and grow the economy appear highly risky, especially those involving an unprecedented Federal intrusion into the private capital system. They have been implemented in an ad hoc fashion with little predictability and consideration for their long-term effects upon the economy. President Obama said in his speech of January 8, 2009, "that only government can provide the short-term boost necessary to lift us from a recession this deep and severe. Only government can break the vicious cycles that are crippling our economy." I respectfully disagree with this statement since it flies in the face of 121 years of economic history prior to the establishment of the Federal Reserve System. During that period, economic volatility was far greater than that which we have experienced since WW2, but the economy did recover and grow, without governmental intervention, from several recessions and depressions.

I expect little bang for the buck from the latest economic stimulus plan since most, if not all, of the anticipated positive economic effects will be offset by an increase in personal savings and a reduction in U.S. exports. The plan's focus attempts to renew personal consumption while supporting housing. Though well intentioned, in my opinion, it is based on rear view mirror analysis in that it does not consider the likelihood that we have entered a new world economic order. If the American public is willing to accept a prolonged period of expanded government spending as a percentage of GDP, possibly in the range of a mid- to high twenty percentage proportion versus a typical 19% to 21%, the U.S. economy will face an even more protracted period of substandard economic growth than it otherwise would. A more viable solution, requiring less government, would be to encourage a transformation of the economy so that exports represent a greater portion of future GDP than their current 12.9%. A shift of approximately five percentage points could possibly accomplish this transformation. As an example, rather than offering consumers an $8,000 credit to purchase a new or existing home, it would have been far more beneficial to redirect this spending to job retraining as well as stimulating employment hiring in industries that are more export oriented. With proper incentives for investment, we could unleash the entrepreneurial spirit of the private sector. Our foreign trading partners will not wait for a recovery in the U.S. consumer's balance sheet to rekindle their own export growth. They will direct a portion of their fiscal spending into new areas that enhance domestic economic growth, thus, reducing their export dependency. We should not be wasting precious financial resources on industries like housing and autos that will not be beneficiaries of this new trend.

My confidence is being undermined by this new financial system and era. The House of Representatives responded to the voices of the mob, when it voted 328 to 93, to punitively tax AIG employees in an ex post facto fashion. Many of these employees committed to aid in AIG's corporate restructuring and expected their employment contracts to be honored. Another example is the repeated attempts by Congress to pass cram down legislation that would allow a first mortgage to be restructured in bankruptcy court. We placed a halt on the purchase of new mortgage-backed securities until this issue is settled. On May 6, the Senate passed safe-harbor mortgage legislation that would limit or prevent mortgage servicers from being sued, should they modify loans under government anti-foreclosure initiatives, by owners of mortgage-backed securities. We smell conflict of interest here since the five largest residential mortgage servicers, who control approximately 67% of this industry, are large recipients of TARP funds. They own billions in second mortgages and home equity loans whose values could be enhanced, if only the first mortgages are restructured; thereby, giving priority to a junior creditor's standing.

Chrysler's bankruptcy reveals further conflicts of interest. The four largest senior secured lenders to the company had previously received $90 billion in TARP money. It looks as though they rolled over to allow the President's plan to move forward. To see junior creditors gain superiority over senior creditors is a bad precedent. It turns upside down the absolute priority rule that is a basis of bankruptcy law. Given this outcome, this new potential political interference risk raises a serious issue in our minds in lending to corporations with high union workforce representation with large legacy employee liabilities. At the very minimum, we will require a higher return to compensate us for this risk. It is all about the sanctity of contract in bankruptcy. As a side note, it was not the hedge funds that forced Chrysler into bankruptcy, it was the company and its unions that created a non-competitive enterprise that drove it down the road to bankruptcy. In a recent WSJ article, an unnamed administration official is quoted as saying, "You don't need banks and bondholders to make cars." [6] Such statements do not instill confidence in capital suppliers. The latest GM settlement proposal extends this adverse trend. Mr. President, you may have won these battles but the true cost of your "wins" will not be known for several years. Your mission to save a few thousand automotive jobs upends a history of prioritization of lender claims in bankruptcy. You are placing at risk fundamental elements of contract law. In the long run, your strategy will likely cost this country dearly. For the record, I do not, and have not, had any domestic automotive company debt in my bond fund for two decades and thus, I have no conflict of interest on this topic.

The President talks about the concept of "sacrifice" in connection with the Chrysler bankruptcy and the economic crisis. We do not see it demonstrated by our elected officials. My associate, Steven Romick, highlights in his latest shareholder letter that, "Congress recently gave themselves a 2.8% pay raise. We would have preferred something more akin to FDR's first 100 days when he cut $100 million, including a 5.6% reduction in congressional wages, as part of "A Bill to Maintain the Credit of the United States Government." [7] Private sector employees and business owners have suffered cuts in their incomes and profits so why should not our elected representatives and other governmental employees experience this pain as well? Why shouldn't they sacrifice too?

We have to be careful about what is meant by "sacrifice." As Alexis de Tocqueville said, "A democratic government is the only one in which those who vote for a tax can escape the obligation to pay it." Given the extreme progressivity of the U.S. tax code, a small proportion of Americans are the ones who really pay for government but most Americans fail to realize it. According to the WSJ editorial of April 13, 2009, by Ari Fleischer, "Everyone Should Pay Income Taxes," he states that the Congressional Budget Office estimates that those who earned less than $44,300 in 2001, approximately 60% of the country, paid 3.3% of all the taxes, and that by 2005 their payments had fallen to less than 1%." This is not a healthy trend, if our democracy is to survive.

This brings me to my last point in this tirade against our federal government and its unsound policies and that is that our federal debt growth is out of control. In my September 2008 shareholder letter, I estimated that incremental new Treasury debt issuance for 2009 could be in the range of $2.5 to $3 trillion on a base of $10 trillion. For the six-month period ended March 31, 2009, Treasury debt outstanding grew by $1.1 trillion. New programs announced by the Treasury, the Fed and a much larger budget deficit total approximately $3 trillion more than my initial estimate range; thus, I believe my forecast will prove to be sadly optimistic. I also believe we will see follow on programs that will add to this total.

I estimate that by the close of 2011, Treasury debt outstanding will be between $14.6 and $16.6 trillion and that the U.S. debt to GDP ratio will rise to between 97% and 110%. By comparison, the highest ratio ever attained was 121% at the end of WW2. Furthermore, my estimates do not include entitlement liabilities or the effective guarantee of trillions of dollars of Fannie Mae and Freddie Mac obligations. Treasury debt service will likely rise by 50% to 100% above the present $450 billion rate and this is with interest rate levels near record lows. A critical question is, "How do we finance all this debt?" Assuming consumers save an additional $650 billion in 2009, we will still be more dependent on foreign sources of financing. Should foreign investors retain their present amount of Treasury debt ownership and then let it increase proportionally to our debt growth this year, additional purchases between $719 and $862 billion are required versus last year's $724 billion. This appears doubtful, given the deterioration in their domestic economies along with rapidly declining exports. To make up the difference, the Fed will be forced to print an additional $800 billion to $1.5 trillion of new money to buy these bonds. Unless Americans increase their personal savings per my estimates and foreign investors boost their Treasury ownership by 39% to 57% between 2009 and 2011, the Fed could be forced to print additional money. This possibility may unnerve some of our trading partners, particularly the Chinese and the oil exporting countries.

Restricting debt growth will be difficult, if not impossible to do since it will require the Congress making unpopular decisions while unemployment remains elevated. In a similar fashion, the Fed will find it tricky to retract the excess liquidity it has created as well as eliminating the various asset purchases and guarantee programs it has established. I do not have confidence in the government's ability to execute these policies, given the history of the regulators, the Congress and the Executive branch choosing to ignore the excessive growth that took place at both Fannie Mae and Freddie Mac, while looking the other way on numerous other financial institutions, including AIG and the investment brokerage firms. For over three years, Fannie and Freddie operated with excessive leverage and without public financial statements while the government twiddled its thumbs. In contrast, FPA saw these problems three years ago and made the difficult decision to place all of these companies on its investment restricted list. We would not reward bad behavior. I do not see government rising to our standard.

What gets me is that this outrageous size and continued growth in debt and off balance sheet entitlement liabilities is effectively stealing from our children and future generations. As Thomas Jefferson said, "Loading up the nation with debt and leaving it for the following generations to pay is morally irresponsible" and "To preserve independence, we must not let our rulers load us with perpetual debt." These sentiments ring true today except with our elected representatives. Who is to blame for this tragic set of circumstances? We are. If we, as citizens and providers of capital, do not attempt to exert control and discipline over our government, who will? At FPA, we will not lend long-term money to this irresponsible and fiscally inept government nor will we to other irresponsible borrowers. We are exercising nothing less than our fiduciary responsibility.

Outlook

My financial market outlook is rather cautious. I believe the recent stock market rally is nothing more than a bear market rally. It is being driven by some highly optimistic expectations. A narrowing in credit spreads is encouraging some "experts" to express the view that the worst of the credit crisis is over, especially with the economic stimulus plan benefits yet to come. Many economists are forecasting an end to the recession by year end, and I have even seen one anticipating a "V" shaped recovery. If my previous comments about the stimulus plan prove to be correct, these forecasts will be wrong. With a continuing weak economy, particularly among consumers, corporate earnings growth will disappoint. Over the last four years at FPA, we have argued that both reported corporate profits and profit margins were unsustainably high. This assessment has proven to be correct for financial-service companies and now we believe this process is extending to non-financial corporations. We estimate that at their peak, corporate profit margins were approximately 30% higher than previous peaks. With a return to more normal profit margins and substandard economic growth, I expect the stock market to be price constrained for the next ten years. This analysis tends to support my estimate that it may also take ten years for U.S. consumers to rebuild their balance sheets.

The fixed-income market faces many challenges that include an explosion in Treasury debt issuance and a return of energy price inflation, within three to five years. In light of this, FPA New Income's portfolio remains defensively postured, with a short duration that has averaged approximately one year or less for the past six years. I view the Treasury market as being in bubble territory with foolish leaders at the helm of our economic ship.

It appears that we have seen the worst of this credit crisis in the sense that we went over a waterfall but the river is still flowing south. The bulk of the economy's credit problems are still to come, as charge-offs on trillions of dollars in loans remain to be recognized.

The credit markets are gradually reopening but they are still supported by massive federal programs and guarantees. We do not know the costs of these actions that will have to be paid by future generations of Americans. In the short run, the 1979 Chrysler bailout looked like a winner, but from a longer term viewpoint, did we accomplish anything? Government economic interference can and will cause a price to be paid; hopefully, it will not be a large one, but I doubt it. We are in the midst of a Grand Experiment that entails high risk while the nation is in its most leveraged position in history. There is little margin for error.

Closing

It is my hope that I have provided you with some new insights and have prompted you to consider how your actions or inactions could personally affect the financial risks facing our country. I believe this crisis has reawakened a sense of budgetary responsibility that has lain dormant in Americans these past two decades. As Americans, we should demand the same of our government. We, as an industry that allocates capital, bear a responsibility to compel our government leaders to return to prudent fiscal management. If they do not, long-term capital should be withheld, as we have done at FPA for the past six years. We must demand this of our elected representatives and if they do not adhere to a strict fiscal discipline, they should be kicked out of office. If we fail at this responsibility, I fear our nation will travel down a dark and treacherous road.

Thank you again Morningstar for giving me this opportunity to share some opinions and insights at this conference.

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