

THE LANCZ LETTER

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FINANCIAL FOLLIES PART DEUX

One year ago in our “Investors Wake Up to Risk” issue, we followed our initial warnings concerning real estate and the financials from four weeks prior with the following:

“The financial sector comprises over 20% of the S&P 500 and any further fall-out in the sub-prime arena will definitely have a dramatic and immediate impact in the financials as well as the overall market.”

The Lancz Letter - June 27, 2007

At the time, the overwhelming consensus opinion was that sub-prime was such a minute part of the overall economy that its overall effects would be immaterial. Last summer our research appeared on at least a dozen separate occasions in the national media warning about the ripple effects that sub-prime will create on a global basis. We have to admit that 13 months after our words of warning, these “ripple” effects have been even greater than what we feared. Part of the problem is with the management of these financial institutions. Rather than immediately acknowledge the potential negative developments and be proactive in raising necessary capital and reducing expenses, most bank executives totally underestimated the problem or worse yet, totally ignored it. Fifth Third Bank actually increased their dividend early last summer, showing a total disregard toward the financial environment unfolding around them. Last month, in an all too typical reactive move, Fifth Third raised capital after the stock had already plunged toward single digits and - oh yes, you guessed it - dramatically cut the dividend they recently raised. Last year they could have easily raised capital from a position of strength rather than the dilutive moves many banks are currently pursuing. We do not mean to single out Fifth Third, because so many financial institutions failed to act.

Unfortunately **this failure to act will extend and broaden the ripple effects from this credit crisis, which means that investors should continue to maintain a very selective, cautious approach. Rising energy and food costs, the negative wealth effect and plunging consumer confidence all will provide difficult headwinds for equities.**

Last issue we discussed the problems within the financial sector and explained why we are still avoiding it, or are dramatically underweight in the sector. It is not just those transparency issues that bothered us from day one in trying to value their underlying assets, but similar to tech back at the start of this decade many banks and brokerage firms have lost much of their earnings leverage that was a critical component to their previous escalated valuations. Those high margined products and services that fueled the unprecedented opening of the liquidity spigots are gone for good. In addition, many areas of the country are still going to experience significantly lower real estate prices that have yet to be adjusted on bank balance sheets. In the United States alone there is over \$1 trillion of outstanding home equity loans and as homeowners fall to negative equity, these loans hit the lenders by immediately turning to unsecured from secured loans. When you combine this with the disturbing trend of growing vacancies in commercial real estate and heavy exposure in unsecured construction loans, it is no wonder investors are finally taking our words of warning to heart, even though it may have been a much procrastinated response! In addition, banks do not have nearly the loan-loss reserves that they enjoyed before accounting rules changes after the Enron scandal. This leads us to believe that it will take at least 2 - 3 more quarters before the financial clouds begin to lift and a total assessment of the damage can be made.