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With the CBOE Volatility Index (VIX) at a recent all-time high of 90 just a few weeks ago, a morning upswing of 300 points in the Dow followed by a 500 point drop in the afternoon now just seems like an average day in the market. Extreme volatility, tumbling markets, global contagion of the economic downturn, and a $700 billion emergency bailout package all lead to many questions and few answers.

This issue contains a medley of viewpoints from both the academic and industry side. In a recent Town Hall meeting held at Anderson, Professors Francis Longstaff, Ed Leamer, and Richard Roll discussed how we got into the current economic situation, why this time is not the Great Depression, and ideas on what will it take to revive the economy.

On the industry front, we have two prominent practitioners contributing to this issue. Joel P. Fried, Executive Vice President of PRIMECAP Management Company, talks about the importance of long-term investing and why it makes sense. An exclusive interview with Ric Kayne, Chairman and CEO of Kayne Anderson Capital Advisors, reveals his investing philosophy, thoughts on the traditional versus alternative investment space, and general advice.
An Anderson Town Hall meeting was called on October 1st, 2008. The Senate was to vote on the bailout plan that evening. Prior events included the following: AIG, Freddie and Fannie, Bear and Lehman had collapsed; two major financial institutions, Merrill and WAMU, had disappeared and a possible firesale with Wachovia was very close. Two global financial giants, Goldman and Morgan Stanley were on the brink of failing were it not for the change in their charter and an infusion of outside cash. The credit markets had seized up, there was very little lending and inordinately expensive if it could be obtained at all. Professors Francis Longstaff, Ed Leamer, and Richard Roll shared their views of how we got here and what we should do.

Francis Longstaff:

I’d like to start with a quick timeline of where I think we are, how we got to where we are, and maybe where we’re headed. I think the roots of this can probably be traced back to September 11, 2001. We all remember those events; in the aftermath the financial panic and the markets led to an expansionary, loose monetary policy in order to get the economy moving again. We saw the Fed lowering rates, and basically interest rates declined to one percent, very very low rates historically. And that was needed, it was viewed, to stimulate the economy, and stimulate the economy it did. Very quickly, we had a boom in the housing market, which is great if you owned tech stocks and were smarting over the losses there. Real estate bounced back, and that pulled our portfolios up again. And so there was a big boom in housing, and demand for mortgages.

In the meantime, some of the government agencies, Fannie Mae and Freddie Mac, decided this was a great thing and to jump in there and get involved, and so they expanded their mortgage lending dramatically. They were the lowest cost producers in the market, and had a bit of a competitive advantage in the funding side. So not surprisingly, they stepped up, and a side effect however, is that they ended up crowding a lot of the other financial institutions out of the market who weren’t quite as funding competitive. An unintended side effect is that these other institutions had to do something, and so they said “We can’t compete with the prime conventional mortgages, let’s look for other market niches.” And so, very quickly, they were into all sorts of alternative types of lending, such as Alt-A, option arms, sub-prime, etc. We all know where that went.

These other institutions started realizing they could do this; they’d package the loans, sell them off to investors, some of the riskier pieces were put with hedge bonds, pension funds, etc., while they retained a lot of what they viewed as the safer pieces of mortgage securitizations. So, they thought they were sitting on very high quality paper that was paying attractive spreads. Well, we all know the story. Over the last couple of years, the losses quickly started to materialize, expand, and even the safer pieces of these mortgage securitizations started taking big losses. And then people started to get in trouble, and obviously the people who start getting hit first when you have assets dropping in value are the people that are most leveraged.

Not surprisingly, the first wave of this crisis revealed itself as the most leveraged players in the market, typically Wall Street, the investment banks Bear Stearns, Lehman Brothers, Fannie and Freddie were the first to go. So that basically then led to the next wave. The problem with these financials however, is that they make markets nervous about all financials, not just the Wall Street types that are very leveraged, but also the ones that are better capitalized. Everyone starts getting a little more nervous about who might be in the headlines tomorrow, and so the cost of borrowing starts going up for ALL financial institutions, and for that matter, for everyone else. And so in the recent months we’ve seen some of the prime funding rates like LIBOR start spiking, moving up a couple hundred basis points, from one percent, to two percent, to three percent. It may not sound like a lot, but it is.

These higher costs started showing up in other markets. There’s a market for what we call credit insurance (i.e. credit default swaps). The cost of insurance started going up, and some of these folks that had sold credit protection started seeing their potential liabilities going up. The same thing happens to Allstate when they’re looking at their portfolio, and suddenly hurricanes start showing up in the gulf coast, and then they suddenly realize, “Wow, we may not be as well

Professor Francis A. Longstaff is the Allstate Professor of Insurance and Finance Chair. He is a Certified Public Accountant (CPA) and a Chartered Financial Analyst (CFA). From 1995 to 1998, Longstaff was head of fixed income derivative research at Salomon Brothers Inc. in New York. Longstaff has also worked in the research department of the Chicago Board of Trade and for Deloitte and Touche as a management consultant. His current research interests include the following: Fixed income markets and term structure theory, derivative markets and valuation theory, credit risk, computational finance.

He has published nearly 40 articles in academic and practitioner journals. Many of his valuation models have been used widely on Wall Street and throughout the global financial markets. He has extensive experience as a consultant for many Wall Street firms, mutual funds, hedge funds, commercial banks and other financial institutions, software developers and risk management firms, as well as in litigation support. He is a frequent speaker at practitioner seminars and conferences.
Ed Leamer:
I'm Ed Leamer and my advice is to "take a deep breath, relax." We are not going to have a Great Depression. We're going to get through this. We may have a more severe downturn because of the credit crunch. But remember, it's never going to approach the levels of the Great Depression because the unemployment rate, which has elevated quite a bit already to 6%, is nothing like the Great Depression at 25%. It's fear that is driving down the equity levels, not something fundamental about the economy. Let me focus on the fundamentals, the real economy.

We are in the midst of a major housing correction. Housing problems are a heck of a good indicator of an oncoming recession. We've had 10 downturns since WWII, and problems in housing gave us a very clear signal ahead of eight of them. In only two, it didn't. One was what I like to call the Department of Defense downturn, which was the 1953 event when the DOD cut back defense spending from 14% of GDP to 8% of GDP. There's no way the economy can make a smooth transition from a war-time economy to a peace-time economy at the speed that the Department of Defense demanded and we had a difficult economic time.

The other structural adjustment was the 2001 downturn, which was a business downturn. Businesses invested very heavily in equipment and software, IT, particularly during the Internet rush, and when profitability disappointed, Wall Street at some point insisted you had to have some E in the P/E ratios. And the only way businesses could figure out how to get the E in there was to fire a bunch of people and cut back on their IT budgets. That was a structural adjustment just like the transition from a war-time to a peace-time economy. The old economy didn't come back; we haven't had a resurgence of the ratio of business investment relative to GDP.

One thing that was abnormal about 2001 is that there was no participation in the downturn from housing, cars or consumer durables. The Federal Reserve, through its' interest rate policies, can affect the timing of the building of houses and the timing of the building of cars, but it doesn't have much impact on the total. Normally, in the aftermath of a recession, you move sales of homes and cars forward in time because you didn't get the sales or production during that weak recession. Then you're going back in time and capturing the sales that didn't occur. But in the recession of 2001 both the housing sector and auto sales were
capitalized as we'd like to be! Because of that, the folks that were doing credit insurance get into trouble and start losing money, because they were in essence insuring against credit risks, and suddenly credit risks start rising. That led to the second wave of credit problems in the market, which has been spreading to other sectors. So, to summarize where we are now – well, we're in a bit of a nervous situation right now.

What's going on though, is that we've seen people become more nervous about credit risk. They start wanting to have more and more insurance, and so the cost of borrowing, if you have risky debt, is sky-rocketing. What that means is banks won't be making as much unless they can pass along the higher costs. Recently, their cost of funding at the short end has gone up several hundred basis points. An implication of that is the availability of credit has declined, and a lot of these financial institutions were relying on one day credit, so every day they had to essentially refinance their mortgage. All it takes is for one day in the repo markets for them not to be able to rollover their financing and they're in trouble. But now what's happening is that the term structure is much flatter; the short end has come up, and the long end is about where it used to be. It's much flatter, so it's going to be easier for these institutions to push out their funding maturities, and that's probably going to add some stability to the market.

The real concern right now and I think this is the genesis for Congress stepping in right now, is concerns about bank runs; that people will just panic and pull their money out of financial institutions. Which I personally think, would be a very bad move. We're seeing a lot of money on the sidelines. A lot of people are looking at these prices and saying, things are getting awfully cheap.

Edward Leamer is the Chauncey J. Medberry Professor of Management, professor of economics and professor of statistics at UCLA. After serving as assistant and associate professor at Harvard University he joined the University of California at Los Angeles in 1975 as professor of economics and served as chair from 1983 to 1987. In 1990 he moved to UCLA Anderson School of Management and was appointed to the Chauncey J. Medberry Chair. Leamer is a fellow of the American Academy of Arts and Sciences, and a fellow of the Econometric Society. He is a research associate of the National Bureau of Economic Research and a visiting scholar at the International Monetary Fund and the Board of Governors of the Federal Reserve System. He is currently serving as the director of the UCLA Anderson Forecast.

Leamer has published over 100 articles and 4 books. This research has been supported by continuous grants for over 25 years from the National Science Foundation, the Sloan Foundation and the Russell Sage Foundation. His research papers in econometrics have been collected in Study Econometrics, published in the Edward Elgar Series of Economists of the 20th Century. His research in international economics and econometric methodology has been discussed in a chapter written by Herman Leonard and Keith Maskus in New Horizons in Economic Thought: Appraisals of Leading Economists.
strong. There were no missing sales, no lost sales during that period of time. So when the Fed gave us incredibly low interest rates because they thought the economy needed stimulating, they never thought about the channel through which they would have an impact. The channel is through these two critical consumer components and although the Fed can't affect the total, they can affect the timing. But there were no sales to take from the past because there wasn't any downturn with regard to those sectors in 2001 and 2002. So where did the sales come from in 2003 and 2004? They didn't come from the past; they came from the future. So inevitably, the Fed traded strength in the economy in 2003 and 2004 for weakness right now.

Nonetheless, we have been expecting to get through this mess without a formal recession. We knew there was a problem going forward with both these two critical sectors – homes and cars. We knew that housing was an extremely accurate predictor of recession. We knew that it was peaking out in 2005. And we started to think about what the recession scenario would be like – where is this recession going to hit home and which employment categories are going to decline the most. The critical sectors turn out to be manufacturing and construction. The job market is the amplifier. When you lose a job, that's definitely when you default, see more delinquencies on homes, cut back spending. With construction, we knew workers would be laid off, maybe half a million and that's about what has happened. But manufacturing employment was not apparently at a peak, waiting to fall. The downturn of 2001 was totally different in the sense that we trimmed three million jobs but they didn't come back. In fact, since then, the manufacturing jobs have been slowly and steadily disappearing. Thus we thought: no trimming now without any fattening.

Then along came the credit crunch, which actually started in August of last year when the sub-prime market had its total meltdown. At that time, Wall Street economists and analysts said we're going to have the credit contraction of all time. That's worrisome because that's what the economy depends on, credit to consumers to buy all the stuff you buy at Walmart, also credit to business to expand the real economy. Through the second quarter of this year, the credit contraction has not shown up in the flow of funds accounts. By that I mean, credit to consumers has been expanding, business liabilities have been expanding and there has not been a big credit contraction.

Outside of mortgages, it has been the interest rate not the volume of lending that has changed dramatically. Rising interest rates for consumer and business borrowing are a normal feature of a weak economy because businesses have to worry about problems with debt servicing, though this time the rise in risk spreads has been unprecedented, as fear has taken over the bond markets. In the mortgage market it not just higher costs for loans but also dramatically different lending standards. With all the additional problems now confronting the economy, the recovery of the housing market is indefinitely postponed. Home prices are going to continue to decline, there are going to be more defaults and more delinquencies, and the problem with mortgage-backed securities is not going to go away.

Richard Roll:
I want to say something about these different financial institutions that have either failed or been absorbed by others. Every story is a little bit different and I'm going to get back to that in a moment. Their differences imply that the cure is also going to have to be different depending on what kind of financial institution is currently in trouble, and what we need to help to get them out of that trouble. If you look at Freddie and Fannie, I think a good case can be made for the government being responsible for their demise. But if you look at Bear Stearns and Lehman Brothers, that's certainly not the case. They were highly levered and made a lot of unwise decisions. When financial institutions that are highly levered make a lot of bad investments, they often have problems.

I want to agree with Ed in one thing, that right now, we are not, at least not yet, anywhere close to being in a Great Depression. When I say "yet," we always want to hedge our bets. For instance, about 4% of the mortgages that are outstanding in the country right now are delinquent. In 1934, that number was 40%. So you can see that in the mortgage market alone, we're not even close and probably won't be. The unemployment rate today in the United States is in the neighborhood of 6%. Back in those days of 1934, it was 25%. So up to this point, we are not in a comparable situation.

There are about $11 trillion worth of mortgages outstanding in the United States and about $500 billion of those are currently delinquent. But being delinquent doesn't mean they're worth nothing. Some of them will start paying on schedule again.
One of the provisions in the bill that the Senate is considering is to eliminate mark to market accounting, which is a particularly relevant issue for mortgage “whole loans.” Whole loans are non-securitized mortgages and about 5 or 6 trillion dollars worth of the total mortgages outstanding are not securitized and are held at historical costs on the books of a lot of financial institutions that would be insolvent if those mortgages were marked to market at current prices. The SEC, along with the Financial Accounting Standard Board, is thinking of eliminating mark to market when a company sells part of its underwater whole loan portfolio. Currently, the rule stipulates that the entire whole loan portfolio must be marked to market when any part is sold. But most of us who are trained in free market economics and transparency are horrified by the thought that you could give discretion to different financial institutions as to whether or not they are free to mark to market or not at their discretion.

This entire debate is an example of what, in my mind, is one of the biggest dangers in this current situation: It is not the credit problem per se but the regulatory reaction that might happen in response. Let me mention four different things that are possible cures. One thing that’s a possible cure is that the federal government can buy all of the delinquent whole loans from all the financial institutions in America and try to sell them later. That’s actually one of the proposals that’s part of the Senate bill. The problem with that idea is if they don’t change the mark to market rule, no matter how much capital they have available to buy all those underlying mortgages, the institutions won’t sell them. The reason they won’t sell them is because then they’ll have to mark to market the remaining portfolio for all their other mortgages, which are not worth 100% of their face value. So many financial institutions would be rendered insolvent.

Another proposal would be to have some kind of recapitalization; bondholders of medium- and large-sized banks would exchange some of their debt for equity. That would change the leverage ratio of those institutions. The government doesn’t have to be involved. Why hasn’t this already happened? The bondholders and the stockholders of those institutions for which it’s feasible are waiting for the bailout. Why should the bondholders take a hit and exchange their bonds for stock if they can get the government to pay for the difference? I think that the very fact that the government is considering something like a bailout already affects private actions that might have otherwise taken place.

In certain institutions, recapitalization would work. It won’t work for the smaller and medium sized banks for a very simple reason. The liabilities of those kinds of institutions are mainly deposits. Depositors in checking accounts and CDs will not agree to exchange their deposits for shares of stock in the bank. Can you imagine that kind of a proposal? The majority of banks that are holding whole loans are in this position. So a recapitalization is not going to help them.

What could help them is an increase in the FDIC guarantee and that’s another one of the current proposals. Raising the guarantee from 100 million to 250 million will motivate people who withdraw excess funds from these banks to redeposit them. It’ll also help money market mutual funds, which gets me to my final point, about the commercial paper market. As you probably know, the commercial paper market, which is the short term market that finances most of the industrial businesses and other large businesses, has basically collapsed. And there’s a much bigger danger there that non-financial corporations will find it very difficult to finance their short term borrowings because people have withdrawn money from the commercial paper market and are not willing to lend it, even on a very short term basis, unless they receive tremendously high interest rates. The term structure that Francis mentioned being flat is a prediction by the market that short term interest rates are going to decline over time.

Professor Richard Roll holds the Japan Alumni Chair in Finance at UCLA Anderson. He is also a principal of the consulting firm, Compensation Valuation, Inc. Other business experience includes the Boeing Company where, in the early 1960’s, he worked on the 727 and wrote the operating manual for the first stage booster of the Saturn moon rocket. During 1985-87, he was a vice-president of Goldman, Sachs & Co., where he founded and directed the mortgage securities research group. He has been a consultant for many corporations, law firms, and government agencies, and has served on several boards.

He has published two books and more than seventy articles in technical journals. His 1968 doctoral thesis won the Irving Fisher Prize as the best American dissertation in economics. He has won the Graham and Dodd Award for financial writing three times and the Leo Melamed Award for the best financial research by an American business school professor. Roll is the past president of the American Finance Association and is a fellow of the Econometric Society. He has been an associate editor of eleven different journals in finance and economics.
Long-term Investing

Joel P. Fried | Executive Vice President, PRIMECAP Management Company

Adapted from remarks delivered October 24, 2008 during UCLA Anderson Alumni Weekend.

Some people say that timing is everything. Well, two weeks ago, we all suffered through the worst week in the history of the stock market, and today I stand before you to discuss the virtues of long-term investing. How’s that for timing? We have all been saturated over the past couple of months with media reports detailing the crisis facing our financial system. It’s arguably the most severe crisis since the great depression, and accordingly, we are witnessing the greatest government intervention in our financial system since that period.

Ironically, I think this presents an ideal opportunity to take a step back from the crisis that has preoccupied and paralyzed the financial markets, and talk about the notion of long-term investing. Irrespective of the current turmoil, it is an idea that many consider archaic. In contrast to my opening remark that timing is everything, one of the points I hope to leave with you today is that timing is not all that important in long term investing. In fact, as I will show, trying to time the market is a hazardous endeavor.

The most important element of long-term investing is to simply stay invested. A good place to start is with a figure that hopefully everyone finds encouraging. Figure 1 is a chart of the Dow Jones Industrial Average from 1896 through October 10, 2008. So, it includes the worst week in the history of the market. It’s difficult to read on this chart, but there are 113 political and economic market-influencing events labeled. Despite the 20+ recessions, highlighted in grey, and all of the challenging times, including the current period, the stock market’s long term trend is unmistakable. It is up. The Dow Jones Industrial Average has increased from 40 to roughly 8,500. Including the dividend yield, that represents an approximate 9.5% annualized return for the 112 year period.

I have embraced the notion of long term investing by working the last 22 years at a firm called PRIMECAP Management Company, where I have the distinct privilege of working with a group of colleagues that are as passionate about long-term investing as I am. We are long-term fundamental investors and manage about $45 billion in domestic equities. Roughly two-thirds of that is in mutual funds we manage for the Vanguard Group. About one-third is attributable to 25 institutional relationships: corporate pension funds, foundations, endowments, central banks, and sovereign wealth funds. We also mange three mutual funds under our own moniker.

What exactly is long-term investing? Our portfolio turnover during the last 20 years has been in the range of 10-15%. So, we tend to own stocks on average 7-10 years. That, in my view, is long term investing. Conversely, the average domestic stock mutual fund has annual turnover of 85%. This means that on average, mutual funds hold any given stock for a little longer than a year. This is not long term investing. It is, however, behaviorally consistent a society increasingly obsessed with instant gratification.

Let me present three arguments why long term investing makes sense.

1) The long term is the least efficient part of the market.

The advent of the Internet and the proliferation of broadband access have democratized investing and increased short-term decision-making. Every individual with a PC now has the resources to quickly research investment ideas. All news is instantaneously and universally disseminated, leading investors to quickly react to news flow. Assets have rapidly migrated to short-term strategies, like the $2 trillion dollars that until recently was managed by hedge funds.

Penalties for Missing the Market’s Best Days Are Stiff

| All Days 13.4% |
| Excludes Best 10 Days 11.8% |
| Excludes Best 20 Days 10.8% |
| Excludes Best 30 Days 9.8% |
| Excludes Best 40 Days 8.7% |
| Excludes Best 50 Days 7.8% |
| Average Annual Return on T-Bills 6.2% |

Past performance does not guarantee future results.
Source: Federal Reserve, Standard & Poor’s and AllianceBernstein

2) The long term is the most rewarding part of the market.

The long-term performance of the S&P500 is striking. The S&P500 has increased from 100 in 1928 to 1,308 in 2007, a compounded annual growth of 10.0%.

3) The long term is the most widely practiced part of the market.

A good illustration here is the average annual return on T-Bills, which is 6.2% over the same period. The average annual return on stocks was 13.4%, almost twice as much as the return on T-Bills. It is not that investors don’t understand the difference between long-term and short-term investing. It’s just that the temptation to time the market is too great, and the average investor does not have the discipline to stay invested for the long term.

Let me present three arguments why long term investing makes sense.

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The Dow Jones Industrial Average: 1896-2008
Chronological Perspective - Market Resiliency

Shaded areas represent recessionary periods. 2008 data is preliminary through October 10, 2008.

Data Sources: Dow Jones & Company; The Federal Reserve Board; The National Bureau of Economic Research. © 2008 Crandall, Pierce & Company. All rights reserved.

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funds. Add to that algorithmic trading, prop desks at the Investment Banks, and quant shops arbitraging short-term pricing discrepancies; I believe the short term is by far the most efficient segment of the market while the long-term is increasingly ignored and has become less efficient. Thus the opportunities are greatest here.

2) Market timing simply doesn’t work.
Timing when a great investment idea will begin to be recognized by the market is a difficult exercise. Recognition can take many years. You have to be patient. The long-term rewards will compensate you for your patience.

One can relate short-term investing to market timing…trading in and out of a stock as one would trade in and out of the broad market. Most market observers will readily concede that market timing doesn’t work; yet investors continue to aggressively pursue market-timing strategies.

Sanford Bernstein has done some excellent work on the topic of market timing. Bernstein has back-tested practically every popular market timing strategy and found all of the strategies to significantly lag a buy and hold strategy. Table 1 shows the results of two of the most popular market timing strategies tested over 80 years. The first strategy is to exit the market following a losing year, and reenter the market after a recovery has begun. Bernstein defined a market recovery as a 10% gain. The second strategy is to exit the market after a big gain (defined as at least 40%) and to reenter after a year of market decline. As you can see, from the table, the two market timing strategies produced annualized returns of 8.4% and 8.3% versus 10.4% for the buy and hold investor who stayed invested in the market for the duration. That may not seem huge, but let me put the power of compounding into context. On a $100,000 investment in 1926, the market timer’s profits would have lagged the buy and hold investor by roughly $250 million dollars. Most market timers are not as disciplined as the strategies Bernstein tested, and would fare considerably worse. Investors fall prey to emotions and consensus thinking, and have an uncanny habit of consistently doing the wrong thing.

The reason market timing is doomed to failure is that market returns are highly concentrated, beyond anything common sense would suggest. Bernstein studied market returns from 1970 through 2007 and found that the market returned roughly 1% per month over the 37-year period. But that is a deceptive number. The entire gain for the period came in the best 60 months or 13% of the sample period, where returns averaged 7.7% per month. Market returns averaged zero in the remaining 394 months or 87% of the sample period.

Chart 1 is a more striking illustration. Over the 33 year period between 1974 and 2007, if an investor was out of the market for only its 10 best days that investor’s annualized return would drop from 13.4% to 11.8%. Thus the only chance a market timer has of beating a buy and hold investor is if his entry and exit is absolutely perfect, and that is impossible over an extended period.

3) Compelling common sense.
If you accept the fact that owning a stock is owning a piece of a business, the argument for long-term investing is rather obvious and compelling. Does anyone really believe that great companies appear, get recognized by the market, maximize their competitive advantage, growth, and profitability in a year? Of course not! The notion is absurd. Great companies evolve over time. Even revolutionary innovation can take years to be embraced. Competitive advantage and momentum in the marketplace similarly can take years and sometimes decades to manifest. In reality, great companies, like great artists, are often only recognized in hindsight.

Let’s think about this in a different way. If you were to launch a great new company…the next Coke or Apple Computer, or Home Depot, or Google, would you only want to own it for a year, and then sell it? Do you think owning it for a year and then selling it would maximize your profits? Yet, that’s exactly what the average mutual fund manager, with 85% annual turnover, is implicitly arguing. Great investment ideas can last a very long time. Twenty-year investment opportunities are a lot more common than you think. However, there will be many

Table 2

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<th>Gains Tend to Come in Bursts</th>
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<td><strong>1970–2007</strong></td>
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Past performance does not guarantee future results.
Source: MSCI, Standard & Poor’s and AllianceBernstein

Bernstein

Long-term Investing, contd.)
years of poor performance throughout a great investment. If your thesis for buying the stock remains intact, selling during these poor periods would be a mistake.

So where are we today? Three weeks ago, our financial system was on the precipice of collapse. The credit markets were frozen. Neither businesses nor consumers could borrow money.

The stock market suffered the worst week in its history two weeks ago (down 18%). The market is down roughly 40% for the year. Investors are pulling their money out of the market. What should we do? Should we pull our money out of the market, or could this be one of the great buying opportunities in decades? We each have to decide that for ourselves, but if you ask me, it seems that an overwhelming consensus has developed, and people are feeling more despondent and depressed than euphoric [see Figure 2]. And as Warren Buffet said in the New York Times last week, be fearful when others are greedy, and be greedy when others are fearful.

Thank you very much.
Interview with Richard Kayne, Chairman and CEO of Kayne Anderson

Adapted from an interview on October 24, 2008 during UCLA Anderson Alumni Weekend. Ric shares with us his background, views on active versus passive management, investment philosophy, and advice for the future.

Pansy Yang: Ric, thank you so much for joining us today. As a successful veteran of the fund management industry, can you share a little about your background with us?

Ric Kayne: I started my investment career trading (and losing money) while I was a sophomore in college. I went to business school at Columbia for a year, where I had the phenomenal opportunity to work in a research department with a Wall Street firm that's no longer here. After service in the United States Coast Guard, I completed my MBA at UCLA GSM in 1968.

Yang: Today Kayne Anderson is a successful $9 billion investment management firm. How did it all get started?

Kayne: John Anderson and I formed Kayne Anderson in 1984 to create a favorable environment to invest our funds and those of people who are comfortable with our style. The philosophy and style were developed over my prior fifteen years in the business. The founding of the firm gave us an opportunity to build deeper and stronger capabilities in the types of alternative investment activities that were the bedrock of my approach. We have always been willing to trade off big upside for more protection of principal on the downside. Our prime strategies have been 1) to attempt to develop a knowledge advantage through fundamental research (value laden investment niches); 2) to focus on free cash flow generating investment opportunities (cows vs. pigs); 3) to eschew leverage; and, 4) to attract great talent (field professional teams in high school games).

While our roots have been in alternative investing, we took a stab at traditional investing. In 1990 we sensed that there was 1) a good time ahead for equity investors and investment managers, and, that 2) our research process could add enough value to high quality stock portfolios to make a difference. We were right about the first and wrong about the second. Kayne Anderson Rudnick grew from $40 million in Assets under Management (AUM) to $11 billion a decade later when we sold the company. At our core, we are investors, and we recognized that business as a marketing business.

Kayne Anderson Capital Advisors, LP has approximately $9 billion in AUM today in a variety of alternative strategies in marketable securities and private equity.

Yang: Active management, the art of stock picking, versus passive management, the belief that markets are efficient and that a buy-and-hold strategy is the way to go, has long been the subject of debate. Where do you stand on this?

Kayne: I believe that investors seeking participation in equities over the long term are best off with passive strategies. In less efficient niches, however, I believe there is room to add sufficient value through knowledge advantage to favor active management.

Yang: With the new markets that we are experiencing, is there still a place for many of the well-known investment strategies, such as momentum investing, value investing, and long-term contrarian strategies?

Kayne: One of our guiding principles over the years is that everything important in financial history happens outside of two standard deviations. I think we are witnessing that kind of a situation now. Tails, in my view, are much fatter than implied by any quantitative analysis of empirical data. We are experiencing today markets that must be considered to be operating in the fat tails. Strategies such as momentum and stop-loss selling, in my view, work until they don't work. When they don't work, it's like the grim reaper. It's not my choice to employ strategies of that type. Just when you get really comfortable that such a strategy is working is the time you should feel most uncomfortable.

Yang: You touched upon your firm's style of investing and fundamental strategies earlier. Is there anything you'd like to add to your general philosophy on investing?

Kayne: My strategy has been to "work liquidity hard," and stand ready to make selected long term, high conviction investments "when the stars line up." By working liquidity hard I mean investing in rate of return securities opportunities, such as arbitrage or high income types of opportunities. We seek to make equity-like returns with a different risk profile and a shorter investment duration.

When I began in business, long term investments would be in companies where I liked and admired management, loved the business, and, most importantly, liked the price. Working liquidity hard has always provided me the cover to concentrate equity investments without obsessing over diversification issues. It also provided me with a benchmark hurdle rate for long term investments. If I was going to give up short term liquidity by going into a long term concentrated investment, there better be ample compensation.
Today at our firm we have specialists in marketable securities that “work liquidity hard” and private equity teams that seek out special longer term situations “when the stars line up.”

**Yang:** What are your views on the traditional approach to investing in stocks and bonds?

**Kayne:** To me, traditional stocks and bonds are of little interest. Stocks remind me of being in a rowboat, trying to cross a large body of water. You may set the course properly to begin with, but the winds, the storms, etc. are what are going to determine where you end up.

Bonds are often used as ballast. They typically produce more income than stocks. That’s good, except that the income without growth that you earn from quality bonds, in my mind is like a ball and chain on the foot of a sprinter. Inflation and taxes typically rob the investment of any real return.

**Yang:** As an alternative investor, let’s go to oil for a moment. OPEC just announced a deep production cut this morning. Russia and Iran and Qatar are rumored to be forming a cartel. What do you think is the future of oil and energy?

**Kayne:** Obviously, there are a lot of different pressures. Over the last year, we’ve had a spurt in drilling activity driven by the high prices. That spurt has led to an excess of natural gas production over demand and, ultimately, falling prices. With the steep price declines we have experienced in the last six months and the tightness of the capital markets, the drilling boom is over. Budgets are now being seriously cut back. Naturally, an economic slowdown softens demand, but the thing that’s not really well-understood is that there are steep decline curves in the mature oil fields around the world, and vicious decline curves for U.S. natural gas wells. It won’t take too long before we erase the five or six percent surplus gas we’ve been producing.

We believe the tremendous rise in oil and gas prices in recent years was born out of a long period of low prices and systemic underinvestment during the ’90s. The marketplace was not prepared for the incremental rise in demand especially from the emerging markets. Price response was very swift and very harsh. My guess is we’re on the backside of that now. I believe prices, however, will bounce around, but will move towards where the Saudis (the real swing player) want them which appears to be around $100 per barrel. Alternatives will certainly play a role in the future, however, it will take prices in excess of today’s prices, without significant subsidies, to justify their introduction. I’m optimistic, however, that within a decade or two if we pursue a thoughtful and economic multipronged approach, soaring energy prices will not hold us hostage.

**Yang:** Final question regarding the alternative space - how can individual investors gain access to alternative markets?

**Kayne:** There’s a blurring of the distinction between traditional and nontraditional investment opportunities. There are some excellent specialty closed-end trusts that represent participation in various different alternative arenas. The areas that offer the most extreme value today, in my view, are the areas where there are heavily leveraged participants that are being forced to de-lever. In the last year, for example, the entire municipal arbitrage industry was eliminated causing severe selling pressures that pushed municipal bonds to unimaginable prices. While there is still value in that sector, time has healed some of the damage. Closed end trusts with quality holdings in municipals would have been a good choice then.

One of the latest areas of carnage has been the convertible bond market. This is an area where funds have bought bonds and shorted stocks, all on high leverage. Market pressures have forced many of those funds to sell under pressure to reduce their debt. Quality funds that specialize in that area could be interesting.

A word of caution is necessary when dealing in closed end trusts. Be patient in choosing funds and particularly be patient with regard to the price you pay for its shares. Optimally, you want to buy a well-managed fund in an attractive area at a good discount to its net asset value.

**Yang:** As of the beginning of October, retirement plans have lost as much as $2 trillion over 15 months. As one who has weathered through a couple of cycles, what kind of long-term advice can you give us? Many have argued that this is a market that we have never seen before. Have the rules changed?

**Kayne:** I suggest that people work out, keep themselves healthy. My son-in-law asked me the other night, what’s good for retirees? Stocks are down all around. What’s important is to stay well.

**Yang:** Indeed! Thanks Ric, for sharing your time and insights with us.

Richard A. Kayne (MBA ’68) is the chief executive officer of Kayne Anderson Capital Advisors, LP, a $5 billion alternative asset manager. He co-founded the firm in 1984 with John E. Anderson, for whom the UCLA Anderson School of Management is named.

Kayne began his career in the mid-1960s as an analyst with Loeb, Rhodes & Co. in New York. Prior to forming Kayne Anderson, he was a principal of Cantor Fitzgerald & Co., Inc.

Kayne is a director of Glacier Water Services Inc. and the Jewish Community Foundation of Los Angeles. He also is a trustee of the UCLA Foundation.

In 1966, Kayne earned a B.S. degree in statistics from Stanford University. He received his MBA from UCLA Anderson School of Management in 1968.
Laurence D. Fink (BA ’74, MBA ’76), chairman and chief executive officer of BlackRock, has provided real vision and leadership to the Center for Finance & Investments as chairman of its board of advisors since its inception in 2006. Recently, Fink matched his intense dedication with an equally powerful gift of $10 million from him and his wife, Lori. In recognition of their generosity, the school will rename the center the Laurence and Lori Fink Center for Finance & Investments (Fink CFI).

“I am deeply grateful for Larry and Lori’s extraordinary support for the school,” says UCLA Anderson Dean Judy D. Olian. “With their vision and commitment, we will further enhance the reputation of the center throughout the finance, academic and professional communities, having an impact on national and global financial markets.”

The Finks’ $10 million endowment is the largest individual gift to UCLA Anderson since John Anderson’s naming gift in 1987. Portions of the investment will be used to create the Laurence and Lori Endowed Chair in Finance to support research in finance and to establish Ph.D. and MBA fellowships for students. Students will also gain greater access to financial market tools and networks, enhancing their career preparation. The center will partner with the newly launched Master of Financial Engineering (MFE), a one-year program that provides an in-depth study in finance that is more quantitatively oriented than traditional MBA curriculums.

The Finks’ gift and all lead gifts to the Fink Center for Finance & Investments were celebrated at an unveiling ceremony to reveal the Fink CFI Patrons Wall located in Entrepreneur’s Hall. Donors of $500,000 or more to the center are acknowledged on the wall with a plaque and biography. The Fink CFI Patrons Wall ensures their legacy of philanthropy and leadership are commemorated in perpetuity in the Anderson learning community.
A prominent leader on Wall Street, Fink is chairman and chief executive officer of BlackRock, the largest publicly traded investment manager in the United States. He is also a trustee of the BlackRock Equity and Bond Fund Complex within the firm’s open-end fund family.

In addition to his accomplishments in the world of finance, Fink and his wife have been extremely generous philanthropists to the academic and medical communities. Currently, he serves on the board of trustees at New York University (NYU) and also as co-chairman of the NYU Hospitals Center Board of Trustees. Last year, Fink was the recipient of the John E. Anderson Distinguished Alumnus Award, the highest recognition that UCLA Anderson bestows upon alumni.

Tracy Mlakar, Senior Writer for Assets Magazine
October 17 | Fink Center Global Finance Conference
Jointly sponsored by Center for International Business Education (CIBER)

80 faculty, practitioners, doctoral and MBA students attended the Fink Center Global Finance conference held at UCLA Anderson on October 17th. Professor Roberto Rigobon (MIT) discussed the global contagion from the subprime crisis – defining financial contagion to be the transmission of a shock from one country to another, above and beyond what fundamentals can explain, and sharing various theories of contagion as well as different forms of measuring it. Sith Chaisurote, doctoral candidate at Stanford and winner of this year’s CIBER student award on global research, presented his work on the impact of privatization in Brazil on the equity markets throughout Latin America in terms of liquidity and price effects.

Professor Luigi Zingales (Chicago GSB) gave a keynote presentation on trust and finance. Luigi motivated his talk by explaining that the word “credit” comes from the Latin word “credere”, which means to trust; hence, finance is intrinsically related to trust. He discussed objective versus subjective trust, measures of trust, recent research, including his own on the effect of trust in financial markets and stock market participation in particular, and the role of government intervention in attempting to restore trust.

Dr. Michel Crouhy (NATIXIS) discussed causes and remedies of the credit market turmoil. Specifically, Michel talked about what went wrong in risk management and risk modeling, lessons to be learned, and the need for a second generation of pricing models for credit derivatives. Dr. John Rutledge (Rutledge Capital) wrapped up the conference by presenting a framework to better understand China – U.S. economic relations with a discussion on thermodynamics, network/system theory, and China’s role in global growth and their capital markets.
October 24
Alumni Weekend

Finance faculty and Fink Center board members partnered together for a successful Alumni Weekend! The morning finance breakout session featured Professor Avanidhar Subrahmanyam, a renowned expert in behavioral finance, and Joel P. Fried, Executive Vice President of PRIMECAP, who spoke on long-term investing. In the afternoon, alumni gathered to hear Professor Mark Grinblatt and Ric Kayne, CEO and co-founder of Kayne Anderson Capital Advisors, engage in a lively discussion and share their views on active versus passive management. Professor Stuart Gabriel, Arden Realty Chair in Finance and Director of the Ziman Center of Real Estate, delivered the faculty keynote presentation and explained real estate's role in the nation's economic trends.
FACULTY HIGHLIGHTS

Congratulations to Professors Bhagwan Chowdhry and Tony Bernardo (UCLA Anderson) and Amit Goyal (graduate of the UCLA Anderson finance doctoral program and now a Senior Chair at the Swiss Finance Institute) on their award-winning paper, “Growth options, beta, and the cost of capital”. This paper was awarded second prize at the annual meeting of the Financial Management Association (FMA) in Dallas at the Friday luncheon on October 10th. This prize is awarded once every two years and reflects the opinions of the Associate Editors who voted on the most important contribution to Financial Management over that two year period.

Growth options, beta, and the cost of capital

ABSTRACT
We show how to decompose a firm’s beta into its beta of assets-in-place and its beta of growth opportunities. Our empirical results demonstrate that the beta of growth opportunities is greater than the beta of assets-in-place for virtually all industries over all periods of time dating back to 1977. The difference has important implications for determining the cost of capital. For example, when choosing comparables to determine project beta, one should match the growth opportunities of the project with those of the comparable firm. Assuming a 6% market equity risk premium, accounting for growth opportunities alters the project cost of capital by as much as 2 to 3%.
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