



It is a great mistake, possibly ever perilous, ever to assume that because people are in positions of responsibility, they are therefore behaving responsibly.
David McCullough, historian

Like you, I have watched the credit meltdown for months. There is little I can add to the musings of the pundits, most of whom didn't see it coming but now have all the answers. Congress held hearings which had to be as embarrassing for the participants as it was for me to watch as a citizen. Regulators, smart guys all, sit being grilled in front of a bank of preening politicians, the same politicians who took massive political contributions from the very companies that went in the tank. The wrong people are sitting at the witness tables. Wasn't it Massachusetts Democrat Barney Frank who said that Fannie and Freddie were "solid" not too many months ago? And isn't that Barney Frank on TV right now blaming everyone but himself. The man has no shame.

I am writing this as the House finished voting on the "bailout" program. Speaker Pelosi's leadership skills are so weak that she couldn't convince almost forty percent of her own Democrats to vote with her. That's 95 votes including five committee chairmen. She foolishly relied on Republicans to make up the difference after insulting the same Republicans from the floor. Her failure to lead, or perhaps inability to lead, just cost the Dow Jones almost 800 points. And this woman is two seats away from the presidency!

As this whole thing played out the last few months I had the feeling that I had read this book before. Then I remembered Ayn Rand's classic Atlas Shrugged, a book I read in high school. Ms. Rand was born in Russia in 1905 and moved to America in 1925. She held several jobs until becoming a full-time writer, selling her first screenplay to Universal Studios in 1932. The philosophy she developed is called "Objectivism" which champions free market economics and an individual's power to shape their own destiny. Every book Ms. Rand wrote is still in print and they continue to provoke controversy. Amazon.com shows 1535 customer reviews, about two-thirds of them favorable. The few negative reviews of Atlas Shrugged I read don't like her philosophy or verbosity. I agree that she is verbose, but I don't disagree with some of her observations.

The demise of Fannie Mae, Freddie Mac, Lehman Brothers and Bear Stearns and a list of other banks too long to note here started way back with President Jimmy Carter's Community Reinvestment Act of 1977. The objective was to use the government's power to broaden home ownership to people who were shut out for economic reasons. In the interest of fairness, government pressured Fannie and Freddie to buy loans from banks that were in turn pressured to make loans where no sane person would lend money. Since Fannie and Freddie were willing buyers of all the bad paper the banks could publish, the banks published a lot of it. HUD's web site shows that subprime applications increased from 327,644 in 1997 to 783,921 in 2000. There are no numbers beyond 2000. Even though Fannie and Freddie loosened their credit standards, they were seen as absolutely secure so banks, brokers and insurance companies were willing to buy mortgages and mortgage-backed securities. The mortgage securities were then sliced and diced by Wall Street into unrecognizable pieces. Hedge funds even borrowed money to buy the pieces. When the first financial domino fell over, it started a reaction that could not be stopped. And all of this began because government wanted "fairness," not equality of opportunity but equality of outcome.

Ah, fairness. It's the hallmark of Senator Obama's stump speech as he seeks the Presidency. The senator promises tax cuts for everyone except "the rich" which is an as-yet undefined phrase. This is nothing more than income redistribution which has been a popular theme of Democrats since whenever. It is still being preached in academic circles, most recently in an article about globalization in the August 25, 2008 *Wall Street Journal*.

“Much of economics is about the relative efficiency of market allocation,” said Robert Solow, a left-leaning economist who won the Nobel prize in 1987 . . . Mr. Solow said economists also have to study how best to reroute income “to those who are damaged by otherwise useful developments in the economy from those who profit.” . . . Mr. Solow said, “it’s hard to know what to do about it, other than to accept it and repair it, rather than try to prevent it.”

Many of the characters in Atlas Shrugged accept Mr. Solow’s viewpoint. One character is a pompous businessman named Orren Boyle. Mr. Boyle’s claim to fame is his business acumen, borrowing money from the government to buy small, troubled companies that found themselves in trouble because of government regulation.

[When one person owns natural resources] . . . who gets the benefit of it? Nobody except its owner. Would you say that’s fair? . . . It seems to me that the national policy ought to be aimed at the objective of giving everybody a chance at his fair share of iron ore, with a view toward the preservation of the industry as a whole.

Because Boyle is influential and espouses the politically “correct” philosophy of the time, government money keeps flowing his way. To anyone who cares to listen, Boyle states, “The only justification of private property . . . is public service.” He doesn’t like the idea that some companies have a competitive advantage because they are either smarter or more efficient. Competition is OK so long as no one gets hurt in the struggle.

This whole business of “private property for public service” is a theme one hears in Congress today. It isn’t “fair” that Exxon Mobil earns so much money. Congress needs to enact a windfall profits tax, taking from the owners (shareholders) their rightful earnings and redistributing the profits to the public. Outside of government, this would be called theft.

In the book a third generation banker is questioned. As you read this, think about Fannie and Freddie and the philosophy that governed their profligacy.

If people needed money, that was good enough for me. Need was my standard, Miss Taggart. Need not greed. My father and grandfather built up the Community National Bank just to amass a fortune for themselves. I placed their fortune in the service of a higher ideal. I did not sit on piles of money and demand collateral from poor people who needed loans. The heart was my collateral. Of course, I do not expect anyone in this materialistic country to understand me. The rewards I got were not of a kind that people of *your* class, Miss Taggart, would appreciate. The people who used to sit in front of my desk, at the bank, did not sit as you do, Miss Taggart. They were humble, uncertain, worn with care, afraid to speak. My rewards were the tears of gratitude in their eyes, the trembling voices, the blessings, the woman who kissed my hand when I granted her a loan she had begged for in vain everywhere else.

The banker was an ex-banker. His generosity put the bank out of business and he lost the family fortune. His conscience is clear but he is broke. And all the people who were employed by Community National Bank are out of work because the boss was trying to feel good. Too often we forget that the first duty of the ship’s captain is to save the ship. The duty of the corporate officer is to save the company, not to provide jobs to people who need them. Hence we have periodic rounds of layoffs as executives try to save companies. People who have to make those hard decisions are paid handsomely and deserve the high pay. People who don’t make decisions don’t deserve high pay.

Candidate Obama states in his first autobiography that “Organizers didn’t make any money; their poverty was proof of their integrity.” In Atlas Shrugged, the chief executive of the railroad tells a store clerk, “. . . unhappiness is the hallmark of virtue. If a man is unhappy, really, truly unhappy, it means that he is a superior sort of person.” This is a play on the Biblical idea that poverty is a virtue. Conservatives believe the economic pie grows, that you can get rich with a clear conscience. Liberals believe the economic pie is fixed., that you can grow rich only by taking the assets from someone less fortunate or clever. Stock investors, ever optimistic, reject the idea that wealth is fixed and expect the economic pie will grow and that their slice of the pie will grow as a result.

I used to think that the moniker “liberal” was changed to “progressive” because “liberal” had developed a negative connotation. Returning to Orren Boyle in Atlas Shrugged:

After all, private property is a trusteeship held for the benefit of society as a whole . . . But I guess there aren’t many people in Washington capable of understanding a *progressive* social policy.
[Emphasis added]

We have seen the belief that private property is a trusteeship when commentators say they aren’t interested in “bailing out a bunch of Wall Street fat cats” with the rescue package. Implicit in the statement is that high salaries are not earned and certainly not deserved. We want the best people running our companies but we don’t want to pay them. How many of those “fat cats” had their wealth tied up in company stock options? They worked hard and lived well. They risked losing everything by having so much wealth tied up in the companies they ran. Robert Fuld Jr., chairman and CEO of defunct Lehman Brothers Holdings, was a near-billionaire at the top. The *Wall Street Journal* reported that Mr. Fuld and his wife, Kathy, are trying to sell an extensive art collection and homes in several trendy locations just to stay out of hock. Left behind in the reporting of his financial difficulties and the others are the non-fat cats, the large number of employees of the failed firms who had some of their retirement savings in company stock which is now worthless.

Reporting on today’s events is as selective as Ms. Rand found it to be fifty years ago. Consider the reporters in Atlas Shrugged. I’m sure you will be able to attach some real names to the people described in this quote.

The reporters who came to the press conference in the office of the John Galt Line were young men who had been trained to think that their job consisted of concealing from the world the nature of its events. It was their daily duty to serve as audience for some public figure who made utterances about the public good in phrases carefully chosen to convey no meaning. It was their daily job to sling words together in any combination they pleased, so long as the words did not fall into a sequence of saying something specific. . .

In Atlas Shrugged the smart, creative, productive people get tired of having the playing field tipped against them. Regulation constantly punishes success and rewards failure. If you discover a new process or design a new product, “fairness” dictates that you will share your creativity with the general population and not profit from your own ideas. (Generic drugs?) Profit is evil. People who profit from the labor of others are evil. Over time, the producers go on “strike,” leaving the less than able to run things because they “need” the jobs and, not surprisingly, things do not run well. Business deteriorates, the economy stumbles, unemployment skyrockets. Yet no one comes to the rescue because there is nothing in it for the rescuer.

For some reason, Americans love to punish success. We don’t have to go back too far to recall that AT&T was broken up to promote competition. Then IBM that was sued for being successful. How about Microsoft, years under investigation? Now Google is under suspicion. In Atlas Shrugged, “it was society’s duty to see

that no competitor ever rose beyond the range of anybody who wanted to compete with him.” While the big banks vacuum up the failing banks, it won’t be too long before someone decides that the market share gathered by Bank of America or Citi is too big and investigations will begin.

As I write this I have to wonder why a competent person like Treasury Secretary Paulson stays on the job. What is he getting out of working with the Congress other than long, sleepless nights talking to the wallpaper? He has, or had, a fortune estimated to be \$500 million. Take your money, Mr. Secretary, and run!!

Clients have not owned bank stocks for a long time and aren’t likely to regardless of how well banks do in the near future. Citigroup has over 300,000 employees. On any given day, if 1% of them screw up, that’s 3000 screw ups a day. Why anyone would own a company with that many screw ups is beyond me. Our lack of an exposure to financials has been less painful because we own other companies. The other companies are down also, but still in business. In these markets, it is hard to be a winner. As a result, I sleep like a baby - waking up crying every two hours in a wet bed.

I’m not saying that the productive people who make business run need to go on strike to teach society a lesson. What I am saying is that it baffles me why competent business people put up with Sarbanes-Oxley, mark-to-market accounting, never-ending asbestos lawsuits and all the other regulations that are nothing more than sand in the gears. Sarbanes-Oxley, also known as the Public Company Accounting Reform and Investor Protection Act of 2002, was passed after Enron, WorldCom, and Tyco shareholders lost money. Clamping down on business six years ago did nothing to prevent the current credit and financial crisis. Most regulation today is designed to punish the 2% at the massive expense of the responsible 98%. In the eyes of Congress, and the IRS, everyone is a crook until proved otherwise.

What I would really like to see is one company, say Exxon Mobil, state that they are a world-wide company, a citizen of many countries, and that it no longer makes sense to keep its headquarters in the USA. It is too expensive and the regulation too burdensome. For the benefit of shareholders, they are moving to Dubai. I know the long arm of regulation will require that the company conform to US reporting standards but there have to be some tax advantages to being somewhere else. This would be a move right out of Atlas Shrugged where companies moved to escape regulation.

What bothers me in this election isn’t the market or the economy. These are transient events, minor compared to the constant threat of China deciding it wants Taiwan, of a nuclear Iran deciding Israel has to go, of another Arab oil embargo or a terrorist attack on a mid-western city. Senator Obama has never had to make a decision in his life of any import other than to run for president. He is not qualified and I’m afraid that his “fairness” rhetoric will lead us closer to a world described in Atlas Shrugged. Raising taxes on the successful to reward those who aren’t, punishing the creative and coddling the unproductive, requiring lending to people who can’t repay, will all lead to responsible people dropping out or at least not working as hard. I’m not sure I know how to invest in a world where equality of outcome is more important than equality of opportunity. As for this market tumble, we have been through it before and will again. It’s never pleasant, but we do get some buying opportunities. Hopefully the crisis will last long enough to do some good research into great companies that are on sale.

Stanley E. Rulapaugh, CFA. Investment Counsel. A Registered Investment Adviser

7505 E. 6th Avenue, Suite 204, Scottsdale AZ 85251-3520. (480) 941-0820. www.serulapaugh-cfa.com

This memorandum is based on information available to the public and no representation is made that it is accurate or complete. Information contained was developed for use by the firm for purposes of establishing investment policy. Any other use is at the reader’s own risk. Quotation with attribution allowed.