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# DIVERSIFIED TRUST

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COMPREHENSIVE WEALTH MANAGEMENT

November 25, 2008

As many of you know, Bill Spitz is a co-founder of Diversified Trust Company and has both served on our Board and been integrally involved with our investment process since our inception in 1994. Last week in Nashville, Bill met with a group of individuals and shared his current perspectives on the investment markets. Given the positive feedback we received from a number of people who attended the meeting, we thought it would be appropriate to distribute Bill's remarks on a broader basis.

Until recently, Bill served as the Treasurer and Vice Chancellor for Investments at Vanderbilt University. During his twenty-two years in that capacity, he presided over a ten-fold increase in endowment assets and achieved consistent top quartile performance among peer institutions. Prior to joining Vanderbilt in 1985, Bill worked in several capacities on Wall Street. He received his undergraduate degree from Vanderbilt and an MBA from the University of Chicago.

Since his retirement in 2007, Bill has taken a more active role with Diversified Trust and also serves on several public company and private institution boards. In addition to his board role at Diversified Trust, he serves on the Board of Directors of Mass Mutual Financial Group, Acadia Realty Trust and London-based Cambium Global Timber Fund. Bill also serves as a member of the Investment Committee for Oxford University. He authored **"Get Rich Slowly: Building your Financial Future Through Common Sense"** and has received the Rodney H. Adams Award for contributions to the field of endowment management and the Hirtle Callaghan Award for Investment Leadership.

We hope you will find Bill's presentation to be of some value during this difficult period for the investment markets and for the economy.

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# Presentation by William T. Spitz

11/18/2008

Bertrand Russell said, *“The whole problem with the world is that fools and fanatics are always so certain of themselves, but wiser people so full of doubts.”*

Despite the fact that I have spent 33 years in the investment business, I am always full of doubts when it comes to the capital markets. While the current financial crisis has reinforced and strengthened many of my fundamental principles and beliefs, it has also generated a number of surprises and created some new doubts. So, today, I thought I would share with you a handful of the lessons that I have learned in recent months and, in each case, I will try to translate those lessons into useful tips for you. I don't want to spend much time on what is actually happening because we are all subjected to an overwhelming amount of media coverage. But, I think the current crisis is attributable to the bursting of three major bubbles.

First, there was a very long term bubble related to excessive use of debt in support of consumption and a concurrent lack of savings. This has been labeled “Affluenza” which is defined as the excessive use of debt in pursuit of the American dream. The second bubble is related to housing and the way it was financed. And, finally, there has been a dramatic crash in commodities. For some reason, this one doesn't get as much press coverage but many of you are aware that the price of most commodities has dropped by more than 50% this year. In any case, the bursting of these bubbles led to a financial meltdown, a global recession, and in all likelihood, profound changes in regulation, the role of governments in the economy, and so on.

So, what have I learned from this crisis? Well, my first “aha” is that most people don't learn from their mistakes. I have a strong intellectual interest in financial crises so I have spent a lot of time studying them. Perhaps the most famous is the Tulip Bulb Collapse of 1637. But, that event probably seems too distant so let me remind you of a few more recent disasters. We had the emerging market debt crisis in the early 1980's, the real estate/savings and loan crash of the late 1980's, the crash of the Japanese market in 1989, the Orange County bankruptcy in 1994, the collapse of Long Term Capital in 1998, and the tech crash in 2001. The circumstances were a little different in each instance but the root causes are the same. They are: greed, complacency, a lack of concern for risk, leverage, complexity, extrapolation of recent trends, and the failure to ask “What if I am wrong?” The critical point is that all of these were once again present in the housing bubble. People just don't learn from past mistakes. You can reasonably argue that each new generation has to learn the hard way, and we should therefore not be surprised that these things happen over and over again. But, each of these disasters with the exception of the Tulip Crash happened during my career, and I'm not that old. So, what does this mean for you? Well, you should assume that there will always be bubbles and do everything in your power not to be seduced by them. There is always a compelling story. Do these sound familiar? “Technology is the answer to all of the world's problems and therefore the only place to invest.” Or, “growth in China and India will result in strong demand for commodities and ever rising prices.” Or, “demographics will keep pushing up the price of housing in the U.S.” When you see the price of anything rise for an extended period and hear a well-articulated rationale as to why that should continue, watch out!

So, here are a couple do's and don'ts. Develop an organized approach to investing, don't change your strategy unless there have been significant changes in your personal circumstances, don't pay much attention to the financial press, and don't listen to people talk at cocktail parties about the killing that they just made in the latest hot investment category.

My second epiphany is that the global financial system is incredibly intertwined. I have always had a global perspective, but I just didn't get the degree to which the globe is now integrated. I also didn't understand that the system is incredibly fragile because it is entirely based on confidence. And finally, I think we all

underestimated the degree to which the underlying or real economy is tied to the capital markets. Who would have predicted the demise of Merrill Lynch, Bear Stearns, or Wachovia? Who could have imagined that a decline in housing prices in the U.S. would lead to the failure of banks in Iceland? Who would have thought that all of the world's capital markets would freeze up at the same time? And, who understood that issues in the capital markets would cause auto sales to evaporate? At the beginning of my talk, I promised that I would translate the lessons that I have learned into useful tips for you. Unfortunately, this one raises lots of questions that I can't answer just yet. For example, is there a safe place to hide in this kind of global meltdown? Is diversification really worthwhile considering that virtually no investment categories have been immune? Are anyone's promises or guarantees of any value? Can we have confidence in any institution? I'm still grappling with these thorny issues so please let me know if you have any great insights.

I can't overstate the importance of the third lesson I have learned. Anyone who depends upon short term borrowing is exposed to serious risk of not surviving. Many people have asked me how Bear Stearns or Wachovia could have failed in a matter of days. It is very simple. If you have to roll over short term debt and lenders lose confidence in you, then you are sunk. These firms had huge assets. But, suppose there are no buyers of those assets at virtually any price. Then you have no way of paying off maturing debt and the next step is insolvency. In the last two months, only the U.S. Treasury could borrow. Banks, industrial corporations, state and local governments, colleges and universities, and individuals were all shut out of the credit markets. It feels as though things are finally beginning to loosen up so maybe the worst is over. But, I think there are several critical lessons here and we can't let a thawing of the credit freeze lure us back into a state of complacency. First, everyone should think about the wisdom of operating with less debt and more equity. That sounds like a little bit of motherhood and apple pie but most adages are grounded in at least some wisdom. Second, everyone should think about matching assets and liabilities. Borrowing short to buy long term or illiquid assets is a prescription for disaster. Third, any borrower should think about how they will meet their debt obligations during periods of stress such as a downturn in business or the inability to liquidate assets. And, finally, liquidity is king. Once again, everyone should think hard about the amount of cash that they maintain on their business or personal balance sheet.

The last thing that I would like to discuss is human emotions. We all know that markets are driven by fear and greed. But, I have to tell you, I have been absolutely stunned by the swings in emotion during the past few years. In 2006, I gave a series of speeches in which I argued that people were too complacent and that the world was unfortunately still a risky place. Well, today, I would take the opposite position. The markets are behaving as if the world is coming to an end. While there are certainly plenty of things to worry about, it probably isn't that bad.

So, how do you know how people are feeling? Well, of course, you can ask them. But, people often talk the talk without walking the walk. So, it would be better if we had indicators based on what people are actually doing. In fact there are many such indicators so I will quickly discuss four of them. I'm going to use the same format in each case. I will give you a sense of the long average. Then I will compare January of 2006 with October of 2008; a period of complacency versus a period of utter panic. We are only talking about a time frame of two and one half years so I hope that you will be amazed at how much sentiment can change.

First, there is something called the TED Spread which measures the difference between the cost of short term borrowing for banks versus the U.S. Treasury. This is a measure of perceived credit risk and liquidity in the markets. When confidence is high, the spread is narrow because banks are willing to lend to each other at a modest premium over the return that they could earn investing in government securities. And, of course, the converse is true. Well, the long term average is about one half of a percent. So, if the Treasury is borrowing at say 3%, then banks would typically lend to each other at 3.5%. In January of 2006, the spread was 0.2%. In other words, banks were so unconcerned with risk that they would lend at less than half the normal spread. Take a guess at the spread in mid October of this year. It was 4.6%. In other words, banks were so scared that

they demanded almost ten times the normal spread and twenty times the spread that was required only two and one half years ago. Wow!!!

Another measure of perceived risk is the high yield spread. On average, investors have demanded about a 4.5% premium over U.S. Treasury bonds to invest in lower quality or so called junk bonds. So, if intermediate Treasuries were yielding 5%, then investors demanded 9.5% to step down in quality. In 2006, investors had so little concern about potential defaults they were willing to accept a spread of about 2.5%. The world was perceived as a very safe and stable place. Well, take a guess at the spread today. It is about 16%. Said another way, investors think that there is about 6.5 times the risk that was present just 34 months ago. What do you think?

Third, there is an index called the Move which indicates the degree to which investors think that interest rates might fluctuate in the next year. The long term average is about 1%. So, if Treasuries have yielded about 5% on average, then investors normally expect rates to fluctuate in a range of 4% to 6% over the ensuing twelve months. In 2006, the index fell to .6% which suggests that investors thought the world so stable that interest rates would barely fluctuate. Well, in October, the index was at 2.4%. And remember, we are in a period in which long Treasuries only yield about 4%, so a 2.4% range on either side is massive. Once again, this is an indicator of huge uncertainty.

Finally, one can buy a put option on stocks. The cost of this put option is measured by something called the VIX. Like any other kind of option, the cost or premium is determined by the underwriter's assessment of risk. Over time, the cost of a 1 year put on U.S. stocks with no deductible has been about \$4.50 for every \$100. Stated another way, a fee of \$4.50 would hedge the downside in a portfolio of high quality U.S. stocks for one year. In early 2006, the cost was about \$2.25. In other words, investors felt that stocks were so safe that they would write put options on them for half of the historical premium. A couple of weeks ago, fear was so pervasive that the cost hit \$32. That's \$32 for every \$100 that you wanted to cover. That is about seven times the normal rate and fourteen times the rate that prevailed in 2006. As of now, it has fallen back to about \$24 - still five times the normal level.

In conclusion, there are many approaches to investing but there is one word that describes all great investors and that is – skeptical. Wall Street is unbelievably vulnerable to swings in emotion, and the most successful investors are those who are skeptical of the prevailing mood. Market tops occur when most people believe that good times will last forever. Two years ago, you should have been very skeptical of that commonly held view. In contrast, market bottoms occur when everyone believes that things will continue to get worse. And, it makes equal sense to be skeptical of that gloom and doom mentality. Well, I hope I have made the case that sentiment just couldn't be worse. It seems like both the press and virtually every cocktail party discussion are focused on overleveraged consumers, falling home prices, rising foreclosures, a dramatic falloff in business activity, declining corporate earnings, rising unemployment, and the list goes on. Yes, all of these are serious issues. But, everybody knows about them. Stock markets around the world have already fallen by 45-50% from their highs and returns on the U.S. stock market since 2000 are worse than any previous decade in modern times including the 1930's.

I don't know where the bottom is. But, I do know that it is impossible to find an optimist anywhere, and there appear to be fabulous values in high quality stocks, corporate and municipal bonds, emerging market stocks, REIT's, and closed end funds among other categories. So, my advice to you is: don't panic, stick with your investment plan, and if you have any courage, stand up and take advantage of what I think will turn out to be historic opportunities.