THE PEGGOTTY MONTHLY

The Connecticut College

Peggotty Investment Club Newsletter

NOVEMBER 2010

Contents

1 **A Bold Start to a Bull Year**
Gary Ng &
Julian Ferdman

3 **"History repeats itself because no one was listening the first time."**
Justin Conway

5 **Quantitative Easing: Will It Succeed?**
Professor Edward J. McKenna

6 **Macroeconomic Update**
James Green

7 **Market Update**
David Collerd

8 **Interview with Peggotty Alumnus: Menzi Lukhele '08**
Ryan Callahan

9 **The Professor's Corner**
Julian "The Professor" Buffam

A BOLD START TO A BULL YEAR

Gary Ng & Julian Ferdman

This year marks a significant milestone for the Peggotty Investment Club – a student-run investment fund on campus that actively manages a portion of the college endowment – as the club implemented exciting new initiatives and extensive changes to the way the club is organized and run. Our goals are simple, yet ambitious: educate club members on basic fundamental analysis skills, foster intellectual dialogues about the markets and economy, reconnect with the alumni and the rest of the campus community, and optimize the risk-adjusted returns of the portfolio while maintaining its long-term viability for future members.

It has been a busy start to the school year as the current executive board swiftly worked together to propose major amendments to the club's constitution. Under the new constitution, which has been approved by the general board and ratified by SGA in September, the executive board is expanded to included 15 members, who are divided into two committees that are both overseen by the co-presidents. The operating committee – comprising the PR director, secretary, treasury, and education coordinator – is in charge of the smooth operation of the club, which includes designing and putting together this awesome newsletter! On the other hand, the investment committee – comprising the chief investment officer, portfolio

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The Peggotty Investment Club 2010

manager, economic analyst and 6 lead sector analysts – is responsible for originating investment ideas for discussion and leading stock pitches at club meetings.

The restructuring of the executive board was motivated by a need to better engage and educate our members as well as to manage our portfolio more efficiently. As well-known investor Warrant Buffet says, one should only invest in businesses that one understands. But with 30 stocks in our portfolio, it is nearly impossible for every member to have a firm grasp of each company that we own. Thus we replaced the numerous VP positions with the lead sector analyst roles, each heading one of six sectors – consumer, energy/utilities, financials, healthcare, industrials and materials, and technology – and serve as the club specialist for that particular sector.

We also implemented the analyst program, inviting any general member looking to become more involved to apply for an analyst position in one of these six sectors. The response was overwhelming: we currently have 27 analysts – or 4 to 5 per sector team – and they meet with their respective sector captains outside the regular club meeting to discuss the latest market news, analyze stocks within their sector, and prepare stock pitches. Applications are closed for Fall 2010, but we will reopen the application process for Spring 2011 soon. Stay tuned if you are interested!

Beyond reshuffling the organization of the club, we are also streamlining our portfolio so that we can ultimately consolidate our holdings into a smaller, more manageable, number of stocks that is sufficient to achieve optimal diversification. This allows us to focus our energy on tracking the companies we invest in and be more thorough in our analysis of potential investment opportunities. In addition, we are also trying to move the club beyond only analyzing companies qualitatively, by educating and encouraging members to dig deep into financial statements and explore various valuation metrics. This is harder than it sounds at a liberal arts college where not even an introductory accounting course is being offered, but we will continue to ramp up our educational efforts by leveraging on alumni and senior members to impart relevant knowledge to the rest of the club.

And course we must not neglect to mention another new major undertaking of the club that is this newsletter! A big thank you goes out to everyone who contributed to bring our ambitious ideas into fruition, particularly Ryan and Sophie, our PR director and secretary who are doubling up as co-editors! Through the newsletter, we hope to offer current members the opportunity to write thoughtful articles about the markets and economy, reconnect the club with the Peggotty alumni, and provide the rest of the campus with an informative and interesting read.

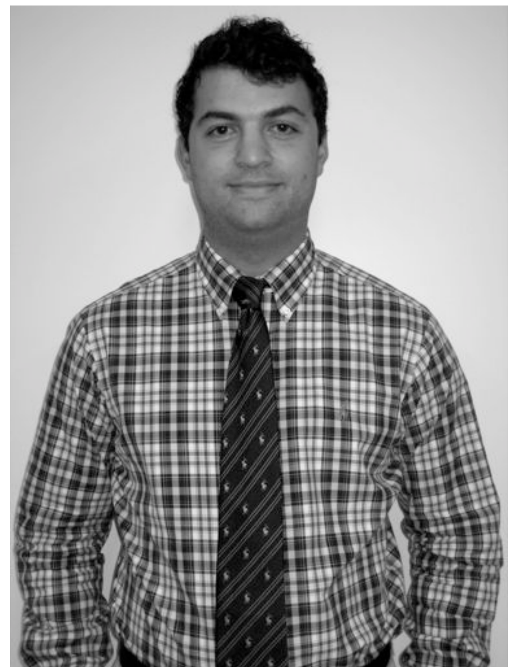
We can go on and on about other changes and new initiatives in the club (e.g. new logo, t-shirts, etc.) but let it suffice to say that it is an exciting time for Peggotty! Members are responding positively and enthusiastically to the changes and we are seeing active membership more than double this year, with the Haines room barely fitting everyone on a typical Monday night. We are proud of what we have achieved thus far, but we also recognize that the club still has much room to grow. With a highly committed executive board, and a growing and reinvigorated membership, we are confident that the future holds even better days for Peggotty.

"History repeats itself because no one was listening the first time."

Justin Conway

Mortality Swap Transaction - This new financial instrument is the brainchild of Swiss Reinsurance Co. and has the potential to sweep the financial world like the most recent financial instruments of the housing bubble of 2007. Mortality swap transactions are eerily similar to credit default swaps, yet no one seems to be worried about the hazards they can possibly create. To understand how they work, let's take a step back to the financial crisis of 2007 to further understand the credit default swap market and how it unraveled.

Credit Default Swaps (CDS) are a form of credit derivative, it derives its value from the underlying assets, and used as a form of insurance for corporations involved in risky endeavors. CDS's were first introduced into the financial markets by JP Morgan in the early 1990's and the market reached an estimated worth of around $45 trillion by 2007. CDS's are essentially contracts that transfer credit risk associated with different debt securities from the holders of the debt to investors who are able and willing to have the risk. This financial innovation was a good thing for financial markets as it allowed for banks to remove their risk and increase their lending. In theory, we know that this is a good thing because it increased the amount of capital going through the financial markets to allow for more investment and growth for firms. In hindsight, however, it fostered an air of riskier lending evident in subprime mortgage loans as well as the creation of riskier financial products like mortgage-backed securities and naked credit default swaps. So what does this all mean for the Mortality Swap Transaction? We will have to look at the underlying structure to understand its significance.



Mortality Swap Transactions work in the same way that CDS's work by removing risk associated with life insurance plans and transferring it to investors. Swiss Reinsurance Co. has already removed $1.5 billion in mortality risk via these mortality swap transactions. How it does this is by using securitization to bundle together different life insurance plans into one pool, creating a new security that it can sell to investors. This is exactly the same thing we saw in the past when banks would use

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securitization to bundle together different mortgages into one pool to sell off to investors. In the most recent case, Goldman Sachs set up a special purpose vehicle (SPV), a shell company that is a separate entity from Goldman Sachs but is backed by a line of credit from them, to buy the Mortality Swap Transactions from Swiss Reinsurance Co. This SPV then raises capital from investors through a sale of bonds. The funds received are then used to buy these mortality sap transactions and since the SPV is a subsidiary of Goldman Sachs it does not have to abide by the same regulation and can use all of its capital instead of keeping reserves. The SPV then makes money from the monthly payments the mortality swap transactions have and only loses money if people in the asset pool die before the actuarially determined point.

At first glance, one might think we are setting ourselves up to be susceptible to the same problems stemming from the financial products that got us into the financial crisis in 2007, the over leveraging of SPV's and the riskier lending due to the creation of financial instruments to sell off risk, but looking at the difference in the underlying risk of the assets tells a different story. The main risks that are associated with mortgages are that the lender is giving the money at the beginning of the transaction and if the borrower defaults on the mortgage, the lender is now stuck with an illiquid asset. In the recent crisis, the lenders probability distributions for defaulting on the subprime mortgages were inaccurate so once housing prices started to decline in 2007 and people started defaulting on their mortgages, the banks were left with devalued assets and low capital. In the case of life insurance, the insurer does not put any cash up at the start, rather, when the benefactor dies the insurer then pays off the plan to the family. As well, the demographic probabilities for early deaths could be more accurately determined and they might be more stable, resulting in less risk than the subprime mortgage crisis. Additionally, there are no tangible assets involved, and like the mortgages, the insurer is receiving a steady stream of cash flows in the form of monthly payments. The only inherent risk the company takes on is that the insured party will prematurely die before the actuarially determined estimate. If that's the case, then the insurer is paying out more money than they received.

Before mortality swap transactions, life insurance companies could only hedge their plans by issuing notes and setting aside the proceeds as a sort of reserve for the mortality risk. The insurer would have to obtain a bank underwriter of the notes to insure the value of the notes as well as to comply with Regulation 30, state regulation regarding life insurance. The main problem with this is that the banks were not privy to taking on mortality risk, so the creation of mortality swap transactions has opened the doors for a new way of hedging risk for life insurers. If the US is not threatened by a pandemic, there seems to be very little risk associated with the Mortality Swap Transactions and they might not be as harmful as the CDS's of the past.

Peggotty Investment Club Portfolio Profile

- Approximate Value of Holdings: $61,000 (as of November 14)
- Number of Positions: 20 Common Stocks, 4 ETFs, 1 Equity Mutual Fund, 2 Bond Mutual Funds
- Academic Year-to-Date Performance: +7%
- Recent Trades: Sold PETM, TWX, NVDA, SAYCY, FTR, AOL and re-invested in INTC *(as part of the process of streamlining the portfolio)*

Quantitative Easing: Will It Succeed?

Edward J. McKenna

With the unemployment rate mired at 9.6 percent, the Federal Reserve recently announced that it will begin to implement a new monetary policy known as Quantitative Easing II. In normal times, the Fed uses monetary policy to influence short-term interest rates. Because movements in short and long-term rates are correlated, the Fed can normally influence all rates by focusing only on short-term rates. However, short-term rates are currently near zero, hence making it virtually impossible for the Fed to influence long rates through monetary policy that focuses on the short-term rate of interest. As a result, the new Fed policy is aimed at directly reducing rates with durations in the 5-6 year range, with the hope that such a reduction in the cost of capital will lead to increases in aggregate demand. Is it likely that the policy will be effective?

One must admit that predictions about the efficacy of this policy are difficult to make, primarily because it has not been tried before and, therefore, there is no historical record to rely upon. Nevertheless, there are good reasons to believe that this policy is unlikely to make much of a dent in the current unemployment problem. Though the $600 billion that the Fed will purchase in longer-term bonds sounds large, as Berkeley economist Brad Delong has noted, this is a rather small sum compared to the size of financial markets. Indeed, Delong estimates that the policy will reduce interest rates by about 1 basis point, and this is very unlikely to have much of an impact on aggregate demand. But, even if real rates could be reduced, it is not at all clear that the problem currently besetting the economy is one of high rates of interest. Rather, two other concerns seem to be at the root of the problem.

First, while banks do not seem to be suffering from a shortage of reserves from which to make loans, they do seem to lack the will to make such loans. This unwillingness is the result of banks attempting to repair their balance sheets, which suffered severe losses as the result of the steep decline in asset prices that occurred during the recent financial crisis. Moreover, banks appear to be extremely wary with respect to the near-term outlook of the economy and, as a result, worry that any loans they extend might not be repaid. Second, business firms are reluctant to take out additional loans to finance new investment expenditures because of the lack of aggregate demand. Business firms are operating at levels significantly below capacity, and, because consumers are deeply in debt and are likely to reduce their own balance sheets, it is difficult for business firms to foresee an increase in aggregate demand that could justify an expansion of capital goods, even if interest rates are low.

For these reasons, it is unlikely that Quantitative Easing II, even if it is successful in lowering real interest rates, will have much of an impact. However, the Fed may have something else in mind. By purchasing bonds, the Fed will be increasing the money supply. Such an increase, if sufficiently large, could generate an increase in the expected rate of inflation. Such an increase would have a number of effects. First, the real interest rate would be reduced. However, as I have indicated above, this would not likely have much impact. However, a second effect that would occur would be a reduction in expected real debt levels, and this could speed up the rate of repair of balance sheets. Third, an increase in the expected rate of inflation would lead to depreciation in the dollar, which would spur the rate of growth of exports. But, is the Fed really likely to generate the kind of increase in the expected rate of inflation necessary for these effects to be substantial? For a number of reasons, the answer is probably no.

The general consensus among economists is that the Fed normally aims for an expected rate of inflation of around 2%. Given the most recent sales of TIPS, the public now holds an expectation of inflation in the 2 percent range. Thus, for Fed policy to be effective, it would have to increase expectations of inflation above the rate it normally seeks to maintain.

Continued on page 10

Professor Edward J. McKenna

Chair of the Economics Department

Macroeconomic Update

James Green

The month of October was an eventful one for the United States economy. The US treasury ended the fiscal year with a budget deficit of $1.29 trillion, which was roughly 8.9% of the GDP. Although this is a rather large deficit, it stands as an improvement from last year's, which constituted for 10% of the GDP. The Federal Reserve has faced pressure to boost spending and return inflation to a healthy level but they have been unsuccessful thus far.

The Consumer Price Index (CPI) saw a lower than expected increase in September of only 0.1%. The CPI is one of the best indicators of spending and inflation in the US economy. This current low in the CPI level has generated worry in the market due to the implication of possible deflation. In an effort to combat this concern, the Federal Reserve has engaged in quantitative easing to boost spending. The Federal Reserve conducts quantitative easing by "printing money" and buying assets from banks in order to free up their balance sheets. The hope is that this measure will encourage banks to make more loans, generating increased spending across the US economy. Expectations of a second round of quantitative easing led to a negative yield at the October 25th 5-year TIPS auction. A negative yield is unprecedented in TIPS auctions' history.

On November 3rd, the Federal Open Markets Committee (FOMC) announced that they would expand their quantitative easing program by purchasing $600 billion in long-term treasuries, which would be completed by the end of the second quarter. To an extent, this constitutes the Federal Reserve's last resort to encourage spending in the economy. Having exhausted all other avenues to generate spending, the interest rate hovers near zero and the required reserve ratio remains very low. Interest rates are expected to remain low for an extended period of time.

The unemployment rate has not improved and still remains at 9.6% but an increase in spending will hopefully lead to an increase in job creation.

The Peggotty Investment Club will monitor the unemployment rate and the Consumer Price Index in the month of November, both of which will be strong indicators in determining the effectiveness of the Fed's quantitative easing program, although the results may not be obvious for another month or so.

Market Update

David Collerd

In the month of October investors saw a real bull market and the S&P 500 was up 3.69%. Every year the month of October is the yearly reporting period for quarter 3 results. This year on average companies have been cutting back inventories and preventing unnecessary inventory build up because they know that the economy is very soft. These bets have paid off and companies were able to produce excellent margins and even for some record profits. Intel (INTC), a Peggotty holding, is a prime example of this. For the 2010 fiscal year they forecasted a very soft market. During the third quarter they produced record profits and revenues while still maintaining excellent margins. They also understand that in 2011 they will be coming out with a new project "Sandy Bridge" that they are hoping will revolutionize portable computing and graphics capability from a microprocessor. Intel is just one example of many companies out there that have used this economic downturn to their advantage, by promoting research and development to create new products while interest rates and the cost of equity is low. This push towards R&D will pay off for many companies and for some companies provide that next stepping stone to being a real player in the global market.

Recent calculations show that American companies have over $2 trillion in cash or cash equivalents; this is an insurmountable amount of cash. The markets have already seen an increase in mergers and acquisitions in the second half of 2010 but in 2011 companies are going to be poised extremely well to take advantage of their cash and begin to start growing again. This $2 trillion dollars in cash along with the $600 billion in QE2 just released last week will provide a great catalyst for growth in almost every industry in 2011.

The markets in October were priced extremely bullish. They had priced in a Republican victory in the House, a possible QE2 of over $500b, and great earnings from companies across the board. As we move into November I see gold continuing to be bullish as the dollar declines and energy commodities to continue their run. For an industry outlook IT looks to be priced well for a continued run upwards. High yielding dividing stocks also look promising as bond yields continue to fall. The financial sector continues, in my opinion, to look like a sector to look at carefully. With the recent passing of financial regulation coupled with a low volume of banking deals there just does not seem to be a real catalyst to move this sector forward. As we move forward into November, we see a consumer driven economy beginning to unfold. I hope that this will allow for growth during the holiday season that will lead into a very bullish 2011.

PEGGOTTY ALUMNUS OF THE WEEK:

Menzi Lukhele '08

Ryan Callahan

Majors: Economics and International Relations

Current Job: 2nd Year Analyst, Citi Capital Markets Origination

Past Involvement in Peggotty: Vice-President of Fixed Income (07-08)

(Menzi is also currently one of three Young Alumni Trustees of the college)

Q: What originally attracted you to finance?

A: Primarily, the challenge of the nature of the work I do as well as the relevance of the industry to the global economy and business. In addition to that, the experience I have gained in advising institutions and governments (agencies, states, cities etc.) on how best to finance themselves for growth.

Q: How did you locate your junior year internship? Do you feel that your experience confirmed your interest in finance and how did it factor in during your senior year job search?

A: I received an opportunity to interview for an internship with Citi through contact with a Connecticut College alumnus (of course this was after multiple trips to New York and networking). The experience I had during my summer internship confirmed my interest in the industry, as well as which business within the industry I was particularly interested in exploring.

Fortunately, there was no "senior year job search for me (I was given an offer to return full time at the end of the summer). But, if I had to go through the process, I imagine that my experience from the summer would absolutely factor into my job search after senior year.

Q: What exactly are capital markets and what is your role in the process?

A: The capital markets business is essentially concerned with raising capital for institutions and governments. Our role in this process is to advise these entities on how best to acquire capital. On the one hand we interface with our clients, on the other hand we interface with investors looking to put their money to work. We provide market intelligence to clients, as to what investors are looking for.

On the execution end, we communicate with investors on behalf of our clients, and work with investors to get them to understand the structure of the financings.

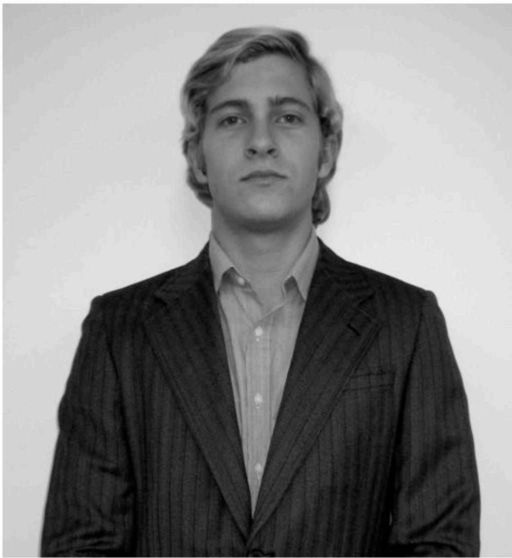
Q: In these difficult economic times, how should a student go about making him/herself marketable to employers?

A: The landscape for entry-level jobs in the finance industry has become more competitive as a result of a distressed labor market, and the increase in the number of graduates interested in the industry. What this means is that the students who will tend to be successful are those that stand out from the fray. Recruiters are looking at more and more resumes for a decreased number of jobs. The goal is to position oneself as a more attractive candidate than one's peers (the truth of the matter is that, this is always the case in good or bad economic times). Part of this includes going beyond the bare minimum in showing your interest in the industry and educating yourself on the business (this is especially relevant for Conn. students, given that the curriculum does not offer a ton of classes on basic finance). For those students who know they want to go into finance early on in their college career, they should do more "groundwork" in getting themselves in a competitive position.

Q: What are the best resources a Conn. student can use improve his/her internship or job search?

A: One of the best resources that one can have as far as job search in concerned (in addition to having the minimum requirements and capability to do a job), is a network of people that can be valuable in the process. On campus, the CELS office is a great resource for information, advice etc. The alumni office is also a great resource for tapping into the alumni network. Also, one should not overlook the network one has within his family and friends.

Continued on page 10



The Professor's Corner

Dear Students,

The Federal Reserve System was first introduced in the United States nearly a century ago and continues to play a prominent role in our nation's economy. The Federal Reserve carries out many responsibilities including conducting monetary policy. The most important tool employed to maintain control over the supply of money and credit in the economy is the buying and selling of government securities. To increase the supply of money the Fed will apply quantitative easing, meaning purchasing government securities such as bonds from banks, other businesses, or individuals. These purchases are funded through the printing of money, which will increase the reserves in the banking system and thus the amount of money in circulation. The financial and economic crisis of 2007 resulted in the Federal Reserve applying quantitative easing in order to stimulate the economy.

Sincerely,

The Professor

Julian "The Professor" Buffam

The Executive Board

Co-President: Gary Ng '11
Co-President: Julian Ferdman '11

Operating Committee:

PR Director: Ryan Callahan '12
Secretary: Sophie Darragh-Nguyen '12
Treasurer: Aminata Ly '11
Education Coordinator: Julian Buffam '13

Investment Committee:

Chief Investment Officer: David Collerd '11
General Portfolio Manager: Clayton Witter '13
Economic Analyst: James Green '12

Sector Analysts: Carson Miller '11 (*Consumer*)
Stanislav Andreev '11 *(Energy/Utilities)*
Daniel Wernick '12 *(Financials)*
Justin Conway '11 *(Healthcare)*
Woody Cissel '13 *(Industrials/Materials)*
Nate Goldman '11 *(Technology/Telecoms)*

If you would like to join the club, or write for the newsletter, please contact co-editors Ryan Callahan (rcallah2@conncoll.edu) and Sophie Darragh-Nguyen (sdarragh@conncoll.edu) for more information.

McKenna

Continued from page 5

While it is true that recent inflationary expectations have been below the 2% norm, making it possible for the Fed to temporarily generate higher inflationary expectations to return the economy to its long-run trend, this would be a risky policy. And, given the number of inflation Hawks in the Federal Reserve, it is difficult to see a consensus coming about within the Fed that could sustain a belief in the Fed's ability to maintain such a finely tuned policy. As a result, is difficult to foresee the Fed undertaking a policy with respect to inflationary expectations that would have much of an impact on the current unemployment problem.

In addition, it is difficult to foresee the dollar depreciating significant enough to affect unemployment in a meaningful way. Exports constitute less than 8% of the United States' GDP, and it would thus take an enormous increase in exports to have a significant impact on the growth of aggregate demand. To have a major impact on the growth of demand would require an enormous depreciation in the dollar, and this is unlikely. For one thing, the price differential between United States goods and those produced by the countries with which we have the greatest trade deficit is so large that only a truly unprecedented depreciation in the dollar could bring about an increase in exports. Moreover, 50% of the U.S. trade deficit is related to oil. When the dollar depreciates, oil-producing countries usually increase the price of oil, thus mitigating the effect of the depreciation.

There are also political effects of such a policy. Since the Federal Reserve began talking about implementing a policy of Quantitative Easing, the dollar has depreciated about 5%. This has led to cries of anguish at the current G20 economic summit by countries such as Germany and China. China's leverage with respect to the United States stems from the fact that it currently holds a great deal of United States government debt. The threat that it might unload such debt, bringing about an increase in interest rates, provides China with a strong bargaining chip. Already there are claims that the United States is trying to export its unemployment problem through depreciation of its currency, generating fears of the type of beggar thy neighbor policies that occurred during the Depression. These fears and political outcries will greatly restrain the ability of the United States in depreciating its currency. Even at home, fear of being viewed as politically weak, which is always the charge that is leveled at a government that depreciates its currency, will limit the ability to implement such a policy. Indeed, Treasury Secretary Geitner, in response to an op-ed piece by former Chair of the Federal Reserve, Alan Greenspan, just stated that the United States would never implement policies aimed at depreciation of the dollar. While this is probably untrue, it does serve to indicate the limits that circumscribed such a policy.

If quantitative easing is unlikely to make much of an impact, why is Chairman Bernanke putting forth such a policy? One is tempted to answer: desperation! Bernanke has indicated that he believes that the present situation calls for some fiscal stimulus. Indeed, if there is ever a time for such stimulus, this is the moment. With interest rates close to 0, government borrowing is effectively free. With unemployment at 9.6%, resources are available for government spending without the need to worry about crowding out. With public investment having been under funded for decades, there is a great need to both rebuild bridges, roads, schools, etc. and to invest in the new technologies that will reduce our dependence on oil.

Alumni Interview: Lukhele '08

Continued from page 8

Q: How did your experience as a Peggotty investment club member affect your interest in finance and your career ambitions?

A: Peggotty is a great platform that will help you stay plugged in with the markets, as well as to assist in cultivating relationships with others that have the same interests in finance as you do. What Peggotty also provided me was the opportunity to put some of the concepts I learned in class to practice.