



DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q4 2008

DOUCET VALUE MOMENTUM PORTFOLIO

DOUCET VALUE INCOME PORTFOLIO

DOUCET MANAGED PORTFOLIO

BIENVILLE MODEL

October 10, 2008

Where is Mr. Morgan?

Baseball, apple pie and, as it turns out, government bailouts – are all great American traditions. Last week’s “Trouble Asset Relief Program” or “TARP” is Congress’ response to the most recent of a long list of banking crises the United States has seen over the past 100 years. Will the most recent banking crisis threaten the American dream?

TARP provides a total of \$700 billion to the Treasury – \$250 billion immediately – to use for the purchase of “illiquid” assets from financial institutions in the hopes of creating economic stability. That’s the good news. The original idea was fairly simple – create a Great Depression-type program to alleviate distress in the mortgage markets – thus providing liquidity for banks and reducing the number of home foreclosures. The bad news is what was originally a three-page plan presented to Congress by Treasury Secretary Paulson, ballooned into a 100 page document by the time the first Congressional vote took place. The bill, of course, was voted down. When the bill reached Congress a second time, it had ballooned to a luminous 450 pages and included vital economic support initiatives like tax exemption for sale of children’s wooden arrows and a tax break for producers of rum in Puerto Rico and the Virgin Islands (now I know why I had such a hard time understanding Barney Frank). Yet, despite the obvious “pork barrel” put in the plan, something needed to be done. Compared to expected tax revenue declines from both corporations (due to declining earnings) and individuals (due to increasing unemployment), coupled with the trillions of dollars (that’s trillion with a “T”) lost in equity markets in just the last several weeks, \$700 billion does not sound quite so bad if the problem is solved. We concur with a recent statement by Warren Buffett, “I don’t think it is perfect...but I would rather be approximately right than precisely wrong. And it would be precisely wrong” to do nothing.

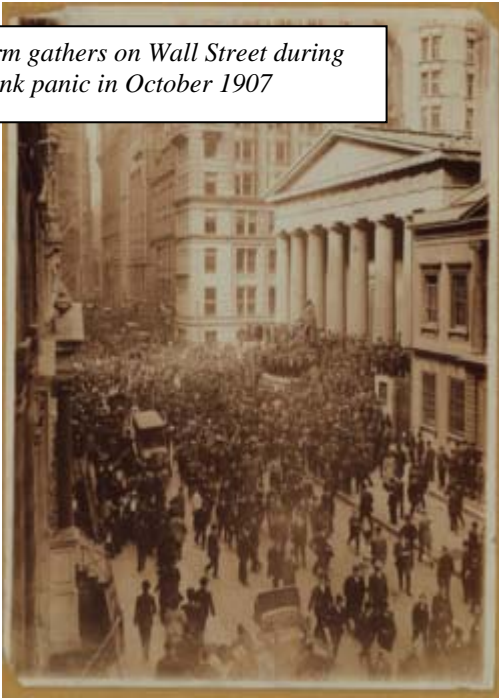
Example from History

Federal Reserve Chairman Ben Bernanke is no doubt looking at President Herbert Hoover’s failures following the 1929 stock market crash as the example of what exactly NOT to do. In the wake of the crash, Hoover failed to immediately reduce interest rates, and instead raised corporate income taxes, discouraged free trade and did nothing to intervene in order to stabilize the economy. The American recession turned into the Great Depression: unemployment reached 25% by 1933 and, at that point, over a thousand people were losing their homes each day to the bank.

As we contemplate America's most recent banking crisis, and the subsequent bailout package,

what comes to mind is not the "Great Depression," but rather the "Panic of 1907." The crisis started simply enough, a major bank was overleveraged which led to its abrupt failure. Word spread quickly, credit markets froze, and confidence eroded causing runs on dozens of banks. Finally, the stock market crashed. Sound familiar? J.P. Morgan, the man, not the bank, was on religious retreat at the time in Virginia (still sound familiar?). Upon hearing about the panic, he boarded a train to New York City without delay. That night, he gathered the influential bankers of his day at his home for an informal meeting. Legend has it, he would not permit these bankers to leave until they had a consensus plan on how to shore up credit in the U.S. as well as a pool of capital to ensure bank deposits before the markets opened the very next day (sounds like our Congress today, except J.P. Morgan actually got something accomplished in only one night). As people discovered their banks were prepared to meet any and all withdrawals, they no longer wanted to make withdrawals. The credit and stock markets reacted almost immediately, and the "Panic of 1907" was over. The lesson we learned from

A swarm gathers on Wall Street during the bank panic in October 1907



that great panic was not much changed the very next day, except for the shot of confidence J.P. Morgan injected into the markets. So the question being asked by many market veterans and students of financial history is, "Where is our Mr. Morgan now?"

What Returns Confidence to our Markets?

Confidence is hard to quantify, but it is unmistakably apparent when it is missing. Likewise, it has become obvious to us that Congress, President Bush, SEC Chairman Cox, Treasury Secretary Paulson, and Fed Chairman Bernanke have not been on our newsletter distribution list. If they were, they would know money, even a \$700 billion liquidity injection, is only part of the answer. The ultimate solution to ameliorate this market malaise requires a return of confidence, just as Mr. Morgan provided in 1907. His last minute heroics cost the American taxpayer nothing and he and his friends made a hefty return on the mere \$25 million they put to work in the markets. The government can inject \$7 trillion into the market, but it will have little effect until investors know that a bottom in pricing for mortgage securities can be found, credit can be restored, and the "every man" is convinced the stock market is not a "rigged game" favoring hedge funds and the institutional investing elite.

While it appears to the reasonable man that the world has gone to "hell-in-a-hand-basket" and a near-term financial recovery is a pipe dream, it is becoming increasingly clear how the parts to the economic engine will be put together. On a positive note, the wheels are in motion. The pieces have been identified, the major issues have been uncovered and the breath of the problem has been determined. Unfortunately for us, there seems to be a delay between the time the American public sees a problem and our leaders address it. Here is an incomplete list of four of the problems, their solutions and progress:

1. Liquidity Is a Small Part of the Problem

The U.S. has been unilaterally reducing interest rates since last summer as well as making other moves to inject liquidity into the financial system. Just hours ago, from this writing, several major central banks from across the globe reduced rates and representatives from the 20 wealthiest countries in the world have agreed to meet this Saturday in Washington DC to discuss the global financial crisis, confirming this is not a U.S. phenomenon. *Businessweek* recently reported that in only the last 25 years, there have been 124 banking crises worldwide. “If you would like an empirical law of government behavior, it is that in a panic or threatened financial collapse, governments intervene – every government, every party, every country, every time.” (Alex J. Pollocak, American Enterprise Institute). Nonetheless, George W. Bush’s former chief financial market adviser said recently, “One thing is clear: this is not a liquidity problem. If it were, all this liquidity we’ve added would have made a difference.” We agree, but it is a necessary first step.

2. Mark to Market Accounting Contributes to Erosion of Capital

Bill Gross, the legendary PIMCO bond fund manager, recently stated that he misdiagnosed the current market problem as a “liquidity” crisis and not a “capital” problem. The quarterly “liquidity” injected in banks is being eclipsed by the “capital” that evaporates due to write downs these financial institutions are forced to take. This massive reduction in corporate capital occurs every 90 days, in part, due to mark to market accounting. Mark to market accounting (part of Financial Accounting Standards Board Statement 157) went into effect on November 15, 2007 and requires companies to reprice their balance sheets every quarter based on “fair value” of the assets and liabilities. In theory, it sounds great – it provides increased transparency for investors. But in reality, it simply does not work. In good times, this mechanism artificially inflates the asset values of financial institutions and gives them the ability to leverage up their balance sheets. In bad times, it forces the mass liquidation (read garage sale) of assets to occur every 90 days in order for banks to stay in compliance with their capital ratios. If the assets of financial institutions were simply composed of T-Bills and certificates of deposit, repricing those assets every 90 days would be simple – not much leveraging *could* occur on the balance sheet but quarterly fire sales of assets would easily be avoided. However, long term assets, like thirty-year mortgages, could not possibly be repriced every 90 days without causing massive fluctuations in asset valuations.

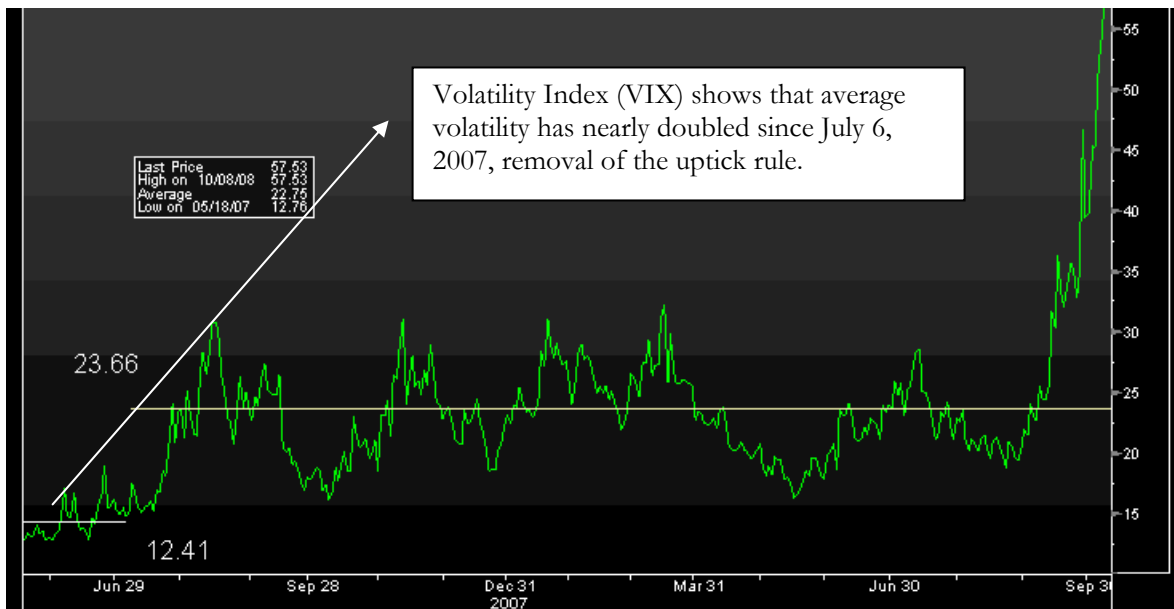
While a form of FAS 157 is necessary to avoid an Enron-like accounting fraud, this specific instrument has greatly intensified the real estate bubble’s burst. The good news is section 132 of the “Emergency Economic Stabilization Act of 2008” (the official name for the bailout plan) restates the SEC’s authority to suspend the application of FAS 157 if the SEC determines “it is in the public interest and protects investors.” Our economic Pearl Harbor continues until this is addressed.

3. The Uptick Rule Creates “Rigged Game”

Joseph Kennedy, father of President John F. Kennedy, was the most notorious “bear raid” artist on Wall Street in 1929. When he was appointed the first Chairman of the SEC by President Franklin Delano Roosevelt, many regarded this act the equivalent of appointing the proverbial fox to guard the henhouse. Despite the concern, he turned out to be the right man for the job, because he knew better than most how to manipulate the markets. One of the steps he took was to establish the “uptick rule,”

an instrument meant to help calm the stock market following the 1929 crash. The theory behind it is a more steady market creates more certainty and confidence in the markets, which in turn, attracts more buyers. The rule requires someone who wishes to sell stock short (selling a stock without actually owning it in hopes that the stock price goes down and thus can be purchased at a lower price at some point in the future) to wait until a stock goes up before he can sell it.

The decision to lift the rule was made by SEC Chairman Christopher Cox. After reviewing a study done with a sampling of 1,000 stocks for the period between May 2005 and April 2006 (a bull market for stocks), Cox determined the uptick rule was “obsolete” and therefore had little effect on the markets. So, in his infinite wisdom, on July 6, 2007, he simply did away with the uptick rule. The volatility in the stock market that ensued immediately following the decision (through today) has been unprecedented. Instead of admitting he made a mistake and simply reinstating the uptick rule, he and the SEC has come up with an arbitrary list of 1,000 stocks in the U.S. that cannot be shorted (where’s the moral hazard in that?). Then he decided the shorts should be allowed to start shorting those stocks again leading to one of the largest single day stock market declines in U.S. history. As you can see from the following chart, since eliminating the rule in July of 2007, the markets have experienced their most volatile time in American history. In fact, the volatility index, which measures the “fear” in the market, hit an intra day all time high one day this week of over 69. No wonder John McCain said one of the first things he would do as President is relieve Mr. Cox of his duty.



Source: Bloomberg

4. End of the Status Quo Special Interest Energy Policy

It took a severe case of national “insecurity” and \$147 a barrel oil before the public was finally able to partially defeat special oil interest and convince Congress to act proactively to help create a plan for American energy independence. Included in the bailout package was a provision for alternative energy tax credits not included in the earlier Energy Bill (signed in June 2008). Congress has wasted billions of dollars on a flawed energy policy in the last 35 years, and especially in the past decade, allowing alternative credits to expire annually. It is absurd to think companies could possibly make these new technologies cost effective and competitive with oil and coal when only a 12 month time frame could be used for planning justification. (Corporations usually do not have the luxury of bailouts to extend their useful life!) Congress finally voted in favor of what constituents have been

telling them: the only way our country regains energy independence is if American ingenuity is given the opportunity to nurture long-term solutions and adequate time to get to their mass production phase. Now, there is opportunity to get the energy independence desperately needed as well as save some turtles and whales in the process. Everyone wins, except for Chavez and Putin and maybe a couple of oil lobbyists. As we have stated in earlier newsletters, just putting an energy policy in place, aimed at breaking the foreign grip on our nation, would be key to confidence in our markets.

Will “Mr. Morgan” Please Come Forward?

Last week’s historic legislation created one of the world’s largest asset management firms; nothing short of the global economy depends on its success. And if you aren’t convinced of the gravity of the circumstance, then turn on CNN. I realize that providing fault-finding opinions on the missteps of “greedy” Wall Street and Washington would keep viewers from changing the channel, but at some point, the level of pessimism becomes a self-fulfilling prophecy propagated by the media. What is lacking is an objective view, as well as a “voice” pointing to the fact the nation has overcome upheavals in its past.

The word “crisis” actually comes from the Greek word for “turning point” (not “end of the world” as you might think listening to media talking heads). Again referring back to 1907, J.P. Morgan’s actions, in concert with other key American businessmen, provided the turning point by returning the faith and confidence in the financial system. This is the single most important element missing today, and stabilization will be nearly impossible until someone steps forward. Several of today’s investment “giants,” such as Bill Gross, managing director of PIMCO, and Warren Buffett, Chairman of Berkshire Hathaway, have publicly stated the desire contribute to the Treasury’s plan. Gross even said that he would work for free (if everyone else did as well, of course) while Buffett, in an interview on PBS said, “With your money (\$700 billion) and my brains, there’s no telling how far we can go.” Confidence will begin to return when a current day Mr. Morgan steps forward.

How Does this End?

Despite the level of desperation visible in the market from simply the sheer volume of activity and the volatility index (VIX), the pieces to complete this solution are at our disposal. The government is acting swiftly and boldly, that cannot be disputed. Other liquidity measures are being instituted as we type this letter. We are beginning to hear calls for the two key structural changes mentioned above, changes which could immediately, and significantly, preserve capital. Our Congress has finally acted on the nation’s demand for a real energy plan. To summarize: Financial recovery will require *Stability, Liquidity, Structural Changes, and Investor Confidence*.

Record levels of cash not only remain in money market funds (around \$3.5 trillion not including the massive amounts of capital flowing into t-bills daily), but American corporations also have equally high levels of cash. Inflation concerns have diminished due to demand destruction and oil prices have declined approximately 40% since July. Yes, the markets are volatile now, but as Warren Buffett says, “Be greedy when others are fearful and fearful when others are greedy.” Finally, Princeton professor and author of *A Random Walk Down Wall Street* Burton G. Malkiel said, “I know money is coming out right now. I don’t know whether this is the bottom. But taking money out now, when things look horrible is almost always the wrong thing to do.”

What should you do during this upheaval? As we have said in previous letters, panic creates opportunity. Echoing this sentiment is Martin Whitman of Third Avenue Funds, who states this is precisely the environment in which patient investors make their fortunes. "Right now is a time when deep value investors excel. People like I got rich in 1974 and 1987...The common stocks of companies that can finance themselves have never been more attractive." We continue to buy positions in cash rich companies that are trading at or near historical low valuations.

Sincerely,



Chris L. Doucet
Chief Executive Officer

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