



## **Market Update from Lone Star Investment Pool's Investment Consultant**

The extraordinary series of events that have swept the global financial system in September and October rank the past six weeks as one of the most treacherous of the past thirty-five years. The elevated aversion to risk that has characterized the market for most of the last fifteen months has been a “flight to quality,” as confidence in the ability of the system to right itself evaporated almost entirely.

While these events have impacted all financial markets to varying degrees, RBC Wealth Management (RBC), Investment Consultant to Lone Star, remains confident in Lone Star's ability to maintain high quality and liquidity in each of the three Lone Star funds. RBC continues to monitor both the current market conditions as well as their impact on the Lone Star funds. We remain in close contact with both Investment Managers and are reviewing each of the fund's holdings on a daily basis. In addition, Lone Star's custodian bank “marks to market” each investment on a daily basis in an effort ensure that the market value of all three Lone Star funds' remains within one half of one percent of amortized cost.

With regards to the Liquidity and Liquidity Corporate funds, RBC also remains confident that the non-government investments represent minimal credit risk. As of October 27, over 90% of non-government investments held by the Liquidity and Liquidity Corporate funds were rated A1+ by Standard & Poor's, which is one credit rating notch above the A1 rating required by both the Public Funds Investment Act and Lone Star's Investment Policy.

As required by the Public Funds Investment Act, each of the three Lone Star funds' continues to be rated AAA by Standard & Poor's, the highest rating a local government investment pool can achieve.

Below are some of the notable events that have occurred recently and their effect on Lone Star:

### **September 5**

The U.S. Government placed Fannie Mae and Freddie Mac into conservatorship, effectively nationalizing the mortgage giants. The two companies are estimated to own or guarantee almost half of the mortgages in the \$12 trillion U.S. housing market.

**Impact to Lone Star:** We believe this event had a positive impact on Lone Star Investment Pool as the debt of both Fannie Mae and Freddie Mac are now essentially backed by the “full faith and credit” of the U.S. Government.

**September 14**

Bank of America acquires Merrill Lynch.

**Impact to Lone Star:** No effect. Lone Star did not and currently does not have any investments in Merrill Lynch.

**September 15**

Lehman Brothers files for bankruptcy, becoming the largest financial collapse in U.S. history.

**Impact to Lone Star:** No effect. Lone Star did not and currently does not have any investments in or with Lehman Brothers.

**September 15-16**

American International Group (AIG), upon its downgrade from AA to A, is faced with the prospect of posting \$15 billion in additional collateral to its derivatives counterparties. Concerned that AIG could collapse soon after the failure of Lehman, the U.S. Treasury moves quickly to contain the worsening crisis by providing the company with a two-year bridge loan of \$85 billion, in exchange for 80% of the firm's equity.

**Impact to Lone Star:** No effect. Lone Star did not and currently does not have any investments in or with AIG.

**September 25**

Washington Mutual (WAMU) the largest U.S. savings and loan, is seized by FDIC regulators. J.P. Morgan agrees to buy the assets and deposits of the failed institution, leaving debt and equity holders with minimal recovery values.

**Impact to Lone Star:** No effect. Lone Star did not and currently does not have any investments in or with WAMU.

**September 28**

The crisis spreads to Europe as Belgium, The Netherlands, and Luxembourg are forced to inject €1.2 billion into Fortis in order to restore confidence in the bank after it came under severe selling pressure the prior week.

**Impact to Lone Star:** No effect.

**September 29**

Citigroup agrees to buy the retail and investment banking units of Wachovia. Although not a bankruptcy or FDIC seizure, Wachovia had become the latest institution to come under pressure over concerns about its residential and commercial real estate portfolios. (On October 3rd, the Board of Wachovia agrees to be sold to Wells Fargo instead of Citigroup). The Government of Ireland announces that it will guarantee all deposits, covered bonds, senior debt, and certain subordinated debt of the four main Irish banks. The guarantee is for an estimated €400-500 billion, or almost twice the GDP of Ireland.

**Impact to Lone Star:** No effect. Lone Star did not and currently does not have any investments in or with Wachovia.

### **September 30**

The U.S. House of Representatives failed to pass the Emergency Economic Stabilization Act of 2008, commonly referred to as the \$700 billion recovery plan proposed eleven days earlier by the U.S. Treasury. The next day, all risk markets plunge, led by the Dow-Jones Industrials 777-point fall.

**Impact to Lone Star:** Generally, positive returns could only be found in the U.S. Treasury money markets. Yields for most money market investments declined drastically.

### **October 3**

The Emergency Economic Stabilization Act of 2008 was approved and signed into law. It authorizes the United States Secretary of the Treasury to spend up to \$700 billion to purchase distressed assets, especially mortgage-backed securities. Although the law was welcome news, it failed to eliminate the overall markets' bias towards risk aversion. The resulting "flight to quality" drove global risk markets lower and significantly contracted the market's appetite for non-governmental money market securities, commonly known as commercial paper. In response to this evaporation of the commercial paper market, on October 7, the U.S. Federal Reserve announced its' plan to begin buying highly-rated, U.S. dollar-denominated commercial paper as part of extensive efforts to restore flows of credit.

**Impact to Lone Star:** This event had no effect on the Pool. It is important to note that a percentage of the Liquidity Fund's and the Liquidity Corporate Fund's assets are invested in commercial paper. We are confident that these securities continue to represent minimal credit risk and will mature at par plus interest. As stated earlier, as of October 27, over 90% of Lone Star's commercial paper holdings are rated A-1+, the remaining holdings are rated A-1.

### **October 10**

Treasury Secretary Hank Paulson announced that the federal government will use the authority it has been granted by the \$700 billion recovery law to buy actual stakes in U.S. banks, in addition to merely buying troubled assets off their books. In response, the Dow-Jones Industrials posted its biggest-ever point gain on Monday, October 13, soaring 936 points.

**Impact to Lone Star:** This event had no direct effect on the Pool.

### **October 17**

The weekly volume for U.S commercial paper transactions indicates that the commercial paper market may be stabilizing as the Federal Reserve sets up its facility to support it. Another positive sign is that the asset-backed segment of the commercial paper market finally grew this week, according to data released Thursday by the Federal Reserve

**Impact to Lone Star:** While this is favorable news, it had no direct effect on the Pool. Yields for non-treasury money market securities began to steadily improve from this point.

**October 21**

The Federal Reserve Board announced the creation of the Money Market Investor Funding Facility (MMIFF), which will support a private-sector initiative designed to provide liquidity to U.S. money market investors. Under the MMIFF, the Federal Reserve Bank of New York (FRBNY) will provide senior secured funding to a series of special purpose vehicles to finance the purchase of eligible assets from eligible investors. Eligible assets will include U.S. dollar-denominated certificates of deposit and commercial paper issued by highly rated financial institutions and having remaining maturities of 90 days or less. Eligible investors will include U.S. money market mutual funds and over time may include other U.S. money market investors.

**Impact to Lone Star:** No effect. However, it is expected that the MMIFF will further improve the liquidity of money market securities.

We hope you find this information helpful. Please know that as market conditions continue to change, we will continue to monitor their effects on the holdings as well as the liquidity of each of the Lone Star funds.



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