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CONVERSATION 3

TRANSCRIPT

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John Mauldin is a prolific writer, financial expert and *New York Times* best-selling author of three books, including *Just One Thing* and *Bull's Eye Investing*. As a frequent guest on television and radio shows worldwide, he is also editor of the widely popular free economic letter, "Thoughts from the Frontline," which is read by more than 1,000,000 readers each week at www.frontlinethoughts.com. Based in Dallas, Mauldin is president of Millennium Wave Investments, and focuses primarily on helping high-net worth investors analyze and invest in alternative investments for absolute returns. The father of seven children, Mauldin and his oldest daughter Tiffani recently started the largest millionaire study done in over 15 years; those anecdotal conversations and interviews will eventually be compiled into a book. Investors can visit his website at www.johnmauldin.com.

Guests



Rich Lashley is co-founder and principal of PL Capital LLC and its affiliates which was founded in 1995 as an investment management and M&A boutique specializing in the banking industry. Importantly, Rich was involved in accounting and auditing services the last time that the banking sector endured an economic and regulatory environment similar to today. Rich was a first-hand participant and observer of the late 80's and early 90's banking crisis and the solutions to that crisis. He is considered a "financial expert" for purposes of Sarbanes-Oxley.



Christopher Whalen is co-founder of Institutional Risk Analytics, the Los Angeles-based provider of risk management tools and consulting services for auditors, regulators and financial professionals. (www.institutionalriskanalytics.com). He leads IRA's risk advisory practice and consults for global companies on a variety of financial and regulatory issues. He represented IRA in various risk management and technical forums, including providing comments on bank regulatory proposals and participating in the US jurisdiction of XBRL International. For the past two decades, he has appeared before the US Congress and the Securities and Exchange Commission to testify on a variety of financial issues such as interactive data, investing and free trade.

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April 2009

John Mauldin

Rich Lashley

Chris Whalen

John Mauldin: Rich, let me throw the ball to you. This is going to be a little bit different today, as a lot of times I am deeply in the conversation, but what banks look like is a little out of my playing field. So I am going to be asking questions and listening to you guys talk. I'll throw in a comment from time to time. So Rich, let me throw it to you and ask, What are you seeing out there? You are looking at the balance sheets of hundreds if not thousands of banks and trying to figure out which banks to buy and sell. What are you seeing?

Rich Lashley: Generally speaking, we are seeing stress across the entire industry. The worst of it is in pockets. Those pockets tend to be in particular areas of the country, so geography matters. If you are in Arizona, California, Nevada, South Florida, you are going to feel some pain. The formerly hot areas are now the cold areas. Everyone in the regional banks, smaller banks, big banks is feeling pain in the construction-lending area because, as we all know, home building is just dead and has been dead for a couple of years; so the banks are sitting on a lot of development loans that they are not going to get paid back. They are going to lose money; they are going to work them out over time; so they are feeling pain there. But generally speaking, most of the banks are healthier and have more capital to survive this cycle than the popular media and the average person would expect. Our basic theme is most of these banks have enough pre-provision earnings to offset the losses. That is not true in all cases, obviously; but generally speaking, most of the banks -- the vast majority, particularly the smaller and

mid-size ones, will earn their way out of this issue. They won't make money in 2009 or 2010. They'll make a little bit of money, lose a little bit of money; but generally speaking, they will come out of this cycle with most of their capital intact -- most of their franchise intact -- and then we'll get back to normalized earnings power at some point in this cycle. I don't know if that is 2011 or 2012 or late 2010, but at some point we will get back to more normalized earnings power. The stocks are trading at such deep discounts, so even where there is stress, I look at it on a company-by-company basis, and I cannot come up with enough losses to justify where the stocks are trading. Our portfolios are trading below 50% of book on average, and that has never happened in the years that I've been watching bank stocks. The only time it came close was back in the RTC cycle, which this is very comparable to.

John Mauldin: What are you seeing, Chris? I saw that you have now rated 2000 banks with an "F". You give them grades.

Chris Whalen: Well if you go back over the last five or six years, we've seen a swing in the banking industry where their loss rates went down to just about zero. You had people like Golden West, WaMu, and Countrywide reporting nearly zero defaults for quarters at a time. Now what is happening is, we are swinging the other way. We are skewing to the same degree we went down in terms of risk. We are now seeing risks skew in the other direction. I totally agree with what was just said; we are probably oversold when it comes to a lot of smaller, low-risk institutions. The trick is finding them and having the deep pockets and the stomach to sit with it if you are willing to go in now. In terms of context for your readers, John, and your audience, when you look at the different asset classes that

affect banks and investors and financials generally, subprime has pretty much peaked in terms of loss rates. That collateral was way out in front, and you are seeing loss rates on that collateral class generally start to go down. Residential, the real prime, fat piece of the residential asset class, is going to peak later this year, again much higher than previous cycles. I'm looking for something like twice 1990 or 1991 loss rates, generally.

John Mauldin: On prime residential and Alt A?

Chris Whalen: That's right. And then commercial is going to be a story that we are going to see unfolding later this year, going into 2010. As we were writing for our clients this week, we are already seeing properties under foreclosure that are trading at 30 cents on the dollar. There were two transactions last week, big fully leased buildings in midtown Manhattan, that were hitting bids of 30-35 cents on the dollar, compared to the previous valuations. Now clearly the previous valuations were too high. So what we are finding is that with cap rates, which are essentially a function of the income from the property, going up dramatically, the investors who own these commercial properties know they can't roll them. The financing doesn't work. The previous valuations don't work, so these properties are going to have to be restructured. Now the good news is, commercial is a market where you have professionals on both sides. It's not a residential retail kind of market, so these deals will be restructured. But I think it's very instructive to see the valuations. The other point I would make real quickly...

John Mauldin: Wait, let me go back to that. When you say these deals will be restructured, you've got a property where

you've been at a cap rate of 4 or 5%, and now the cap rate they are wanting is 9.5% – what that means is that is the amount of income that is necessary to service the loan. It relied upon low rates to begin with, and high income. Now we are seeing that rates have gone up on this stuff, and the income is going down as occupancy is going down. How do you restructure that if you are a bank, to where it is commercially viable for you?

Chris Whalen: Well the lenders aren't, John. The lenders on these properties are foreclosing and they are kicking them out as fast as they can. Now new lenders will come in when the numbers start to make sense again. But for the existing creditors on these commercial properties, especially in markets like New York, which took off and we saw just ridiculous square-footage valuations for these properties, it's coming down. What I'm describing, both in respect to retail and commercial, is the same thing. In other words we saw valuations go to the point where they made no sense, but lots of deals were done there, unfortunately. Now we are going to have to unwind those deals. Let me go back to what we were saying about the banks. Those 2000 banks – half of them are there because of mark-to-market accounting. In other words, of the 2000 banks we rate "F", about half of them are not in trouble; they are simply there because they have a minus sign under their ROE; and with our regime, which is a retail model, we are trying to give retail customers asset allocation guidance so they can move and make sure their funds are under the insured limit. We have to be kind of harsh. I'll give you an example: Regents. I don't think Regents is going to go down anytime soon, even though they are getting kicked around quite a lot. But the negative sign on the ROE made us rate them an "F". Now I will tell you that the FDIC admits publicly to about

250 troubled institutions right now. I think it's closer to 700-800. So, I hope that we are going to see fewer resolutions than during the RTC period. There were a lot of small banks in those days. What was the count, something like 1,400?

Rich Lashley: At the end of 1991, there were about 1,400 on the problem list, and about 270 failed that year.

Chris Whalen: I think we could see a thousand institutions resolved and merged with government assistance by the time we are done with this cycle. But then on the other hand we will see a lot of de novos. Incidentally, of interest to both of you, there is a moratorium, a de facto moratorium by the FDIC, on de novo bank charters in many markets, not all markets.

John Mauldin: Define *de novo*.

Chris Whalen: Well, when you want to start a new bank, what the regulators are saying to investors – my clients are a lot of private equity funds; I'm sure Rich's are as well; but they want us to look at troubled banks first. If an investor wants to get in the game, they will make him a deal on a troubled institution, which is compelling. So I've got two clients who are going into the Fed and the OCC to get what's called a shelf put in place, where you go in and actually get permission to buy a bank – you don't even specify which one. You tell them how much capital you have, you tell them what your criteria, geography, and everything else are; and as banks are resolved by the FDIC they will show these opportunities to investors. And remember, these are completely restructured deals, much like Washington Mutual. The FDIC takes over the bank, they create a new corporation, contribute the assets they think they can sell to the new corporation, and they keep the

toxic waste to work out themselves or sell to different investors; and in the case of WaMu, Jamie Diamond bought a brand-new corporation at 3 cents on the dollar. My brother-in-law is out there foreclosing properties right now, and every time they do – and they have a loss rate that is lower than 97 cents – they make money. That's creative destruction, John. For every loser there is a winner, and we have to enable the winners. That's how we are going to make this economy go again; we have to leave money on the table.

John Mauldin: I wrote, and have been writing for about six months, about the phenomenon of so many of these residential mortgage-backed securities that are selling at 40 and 50 cents on the dollar; but when you look at the internals of them, there is no way they are going to lose more than about 15-20%. And the hedge funds are just sucking these things up, and we are taking taxpayer money to basically subsidize hedge funds and private capital.

Chris Whalen: When it's unnecessary. Today they can get in at the right price, and they are. My friend Kyle Bass down in Texas – he's right down the road from you, John – and he and his colleagues are sitting there doing the work, exactly as you describe, and they are finding value. That is what we need. The government doesn't need to get involved in this. I think a lot of these markets are curing themselves. If you look at munis and other markets that make sense for investors, they are going to cure themselves. The markets that don't make sense – a lot of this private RMBS that was rated AAA at one point but is now busted deals – they will not come back. They will have to be broken up and dealt with by the vulture community, but that is as it should be.

Rich Lashley: Which leads me to a point I mentioned to you last night. I wanted to give you some stats on mortgage-backed securities and the housing crisis as it affects the banks. I think Chris is right, a lot of these RMBS, the Alt A and the option ARMs, and certainly some of the subprime deals, are not going to come back; but the vast majority of that is skewed towards non-bank investors and companies. I find it amazing when I look at some of these stats. In 2008, there were about 3 million foreclosure filings. You hear on TV the politicians, they talk about 2 million foreclosures and then 3 million; they always give the gross number. But there are usually duplicate filings for the same property. So if you take 3 million foreclosure filings in 2008, that is about 2.3 million properties, and there were actually fewer than a million foreclosures. So it's not 3 million; it's really about a million. Then you look down and cut through that 1 million and say, OK, where did that end up? If you take Fannie Mae, Freddie Mac, and the US banks together, which is about 2/3 of the mortgage loans in this country, it's about 7.5 trillion dollars that they hold of the "11 trillion." Overall, at the end of the year, there are only about 170,000 REO properties held by those three buckets (Fannie Mae, Freddie Mac and US banks). Total exposure for those three entities is 22 billion dollars. So we are spending trillions to solve what I think is a rounding error in the scheme of things. It's 29 basis points on the assets of those entities. In the scheme of things, it's a rounding error. So there are two points in that. One is the absolute exposure of the US banks, and even Fannie and Freddie, is not as big as everyone thinks it is; and the other point is, there is a gap between the 170,000 REO properties held by those three entities and the one million that were foreclosed. I think most of those are sitting in investors'

portfolios all over the world, so the pain is going to be spread very widely.

John Mauldin: So you are saying insurance companies and pension companies in Europe and Asia –

Rich Lashley: Hedge funds, you name it, all over the world. And those numbers are a little bit disingenuous, because that is excluding the securities that are held by some of these entities. So if Citigroup has a mortgage-backed security on their books, the 170,000 foreclosures may be sitting somewhere else on the servicer's books, and not on theirs. But the vast majority of the banks we look at are not holding the subordinate pieces, they aren't holding the retained interest. They are holding onto the AAA piece or at worst the AA piece. They aren't going to lose, even in the subprime securities where you have massive loss rates; you really aren't going to eat into the principal of those securities. The problem is as you said; they are all trading at 30-40-50 cents on the dollar, even though the economic losses might be a couple of pennies to 10 or 20 cents.

Chris Whalen: Exactly.

John Mauldin: Let me throw this question up to you guys, as I wrote about this last week. The FASB, the Financial Accounting Standards Board, has basically changed the rules on mark-to-market, and it will be voted on in two or three days, but they are going to make it retroactive to the first quarter. So banks are going to be able to go back and take these residential mortgage-backed securities that they've got on their books, that they are marking down to 40 or 50 cents, and be able to mark them down to economic loss, not mark-to-market. Is that going to give us some real upside surprises at Citi and some of the other big banks and

even smaller banks? How is that going to work into the actual profit and loss statement? How is that going to change your ratings, Chris, because you rated 2000 banks an “F”, but you said half was because of mark-to-market? Does that mean they go back up to “B” or “C”?

Chris Whalen: Oh, indeed. And I think – going to Rich’s comment – I think that’s appropriate for those conservative lenders that basically had a technical accounting rule-driven decision coming up at the end of this quarter. They were dealing with “Other Than Temporary Impairment” or OTTI. What that means is that when the visible price of a security was depressed for more than 90 days, you got to take notice of it and write it down under the old rules. So this new rule I believe is going to allow banks to say, I don’t see a visible price out there that’s worth a damn; I know the markets are disrupted, but the thing is still paying its contract; therefore on a cash-flow basis I think a reasonable estimate will be 80 cents on a dollar instead of 25 cents. That gimme is going to be enough to help the good banks.

Here is the difficulty, though. Citi and the other big dealers of derivatives are not only going to use this accounting rule change to pad Q1, but they are also busy helping AIG unwind its mess. The commissions that have been generating from some of these enormous trades that AIG has been doing in the last couple of months are going to also pad the earnings for the big banks. But the thing is, the big banks are still in trouble. So this FASB rule is going to buy us a bit of time, but the stuff the large dealers own is very different from what Rich was just describing with the smaller banks – and I totally agree on that, by the way. The little guys I’ve talked to have been fairly conservative. But it’s going to be different

for the larger institutions. They are going to have some really difficult problems going into the rest of this year; and other than nationalization, I don’t know how we stop the bleed for the government, because Secretary Geitner and the rest of them seem to be intent on subsidizing the bond holders by putting more equity in front of them, ad infinitum. We could have to put hundreds of billions of dollars into AIG if we don’t push that company into bankruptcy. I’ve told the Senate Banking Committee this. That’s exactly what needs to happen.

John Mauldin: Let’s talk about AIG for a second. What did you tell the Senate Banking Committee, and what are we really looking at? We’ve already shoved 150 billion dollars down its throat. 12 billion of it ended up at Goldman.

Chris Whalen: No, they got 20 in total. They haven’t received it yet, but it’s committed. What’s going on with AIG, John – we are actually going to be talking about it in a comment tomorrow – is that they have been using their balance sheet to essentially help people manipulate earnings and manipulate their capital positions for many years. Even before they got into credit default swaps, they were using a device called a side letter, where they would essentially reinsure a portion of a bank’s or a financial institution’s balance sheet to make that entity look better. Then they would write a little side letter that said, we don’t really expect you to pay out on this insurance, we are just renting you our credit rating for 6% a year. Now, that has gone on in the insurance industry for many years and the regulators just started cracking down on it about three or four years ago. So then all of a sudden we see AIG stop overtly using side letters, and they started growing their credit default swap business. I suspect it was a substitute for the side letters. So you have

a lot of risk all over the world where banks thought they hedged themselves with AIG, but AIG does not have the capacity to pay because they never thought they would have to pay. And indeed the understanding was that they would not have to pay. So here we have the US government making good on these speculative contracts, when the understanding between the parties was that AIG should not have to pay. So we are going to describe that in great detail tomorrow. The whole thing's a fraud. It's a huge fraud, and this company needs to be liquidated. The US Trustee from the Southern District of New York has got another job to do. He is done with Lehman by the way, so this will be next, I hope.

John Mauldin: Well how do we go about liquidating AIG? Everybody keeps saying that poses a huge systemic risk.

Chris Whalen: No. The only risk it poses is collapsing what's left of the credit default swap market, which I think would be a great benefit to the world economy. We've got to recast this options market. That's what it is. Most people who trade credit default swaps use it as a volatility-option-type instrument. They never think about the economic cost of default. The day before Lehman went down they were trading at 700 basis points over in CDS and some other upfront money. The next week, John, when they defaulted, if you had been writing protection you would have had to come up with 9700 cents of cash, because the recovery rate was about 3% for the bond holders and the other creditors. What I am trying to say is that Wall Street does not price these contracts correctly. They price them as though it's an option on a bond, but that doesn't describe the economic cost of default. As I've said to many people, and I've made speeches about this all over the country, I think there are two products here. There is an option that

people need for the public markets to hedge a bond, and then there is a credit default contract, which is a very different animal. That's what's going on with AIG. These contracts are so big and the total dollar amount that has to be funded to be able to pay out on these contracts is so big that liquidation is the only alternative. I think this could affect Goldman Sachs very dramatically, because if there is a bankruptcy filing, you can bet that the trustee is going to claw back those payments, and he is going to want to recover all monies so he can treat all creditors fairly. That is the basic principal of bankruptcy, that the creditors should be treated fairly. Obviously that's not the case here, because Goldman and the other European dealers ran in, grabbed their money, and got paid at par, and everyone else is there waiting to see if they get paid. That's not fair. It goes against everything this country should stand for.

John Mauldin: I don't want to get into conspiracy theories, but why would Goldman and Merrill and all them – if they are in for a dime, why would they now say, well we aren't going to be in for a dollar, we are going to let AIG go down?

Chris Whalen: Because we can't fund it, John. If you start with the GSEs – let's do the math quick. Fannie, Freddie, Federal Home Loan Banks. The bond holders are going to be 100% on the dollar right? No haircut as it stands now, and even given what Rich said about loss rates being relatively modest on the collateral side of the GSEs, they still don't have any capital. So we are going to have to fund their operating losses going forward. I don't know what that number will be, but I think it will be a big number, hundreds of billions of dollars. So then you have AIG. The subsidies for AIG's operating losses – and remember, we are putting equity in front of

the bond holders, that's what we are doing. We've got to keep putting more equity in front of the bond holders or they go into bankruptcy. The number with AIG could be hundreds of billions of dollars, maybe even going to a trillion, because we don't really know what the book looks like, they still haven't fessed up. So let's assume we are going to subsidize that. I think we are well into the trillions of dollars right there, and we haven't even started talking about Citigroup. We haven't started talking about anyone else who may want or need government assistance. I don't think the US Treasury can fund this. We can't go to the market for 200-250 billion in new money every month and roll existing debt. It's just not going to work. And the Fed has told the Treasury that they will not buy auctions; they can help, but they are not going to take down a whole auction.

So that's where we are. I think funding is going to force us to embrace the old-fashioned American tradition of liquidation and bankruptcy because, remember, the reason we have bankruptcy in the US Constitution is not because the founders were nice people and not because they thought people should walk away from their debts; they did it because they knew society needed finality, and the longer these things go on the worse it is for society as a whole. The founders were not fans of democracy, they were fans of the public interest. That's why it is so important for us to get on with this quickly. We are running out of time. Like I said, it is driven by funding. These are cash funding requirements we are talking about here, this isn't notional. The zombies eat money. That's the key point here; we've got to get on with this.

John Mauldin: You are talking about a trillion dollars to fund AIG and some of these others. That's a number that is

unfathomable in addition to everything else we are trying to do.

Chris Whalen: And our budget deficit. Remember, I haven't even talked to you about the deficit spending we are doing on the fiscal side; I'm just talking about subsidies for financial institutions. And as Rich said, most of the other banks out there are paying for this; they didn't do these stupid things. When the FDIC came out with that special assessment, just about every state delegation showed up to see Sheila Bair the next day with their Senators and Congressmen in tow, and what they told her was, you can't do this to us. Your assessment is 150-200% of what our banks made in 2008. You're confiscating our capital. So what I think is going to end up happening is that the Treasury is going to have to shoulder the load. The industry will contribute, and as Rich said we are going to have to stretch this out over time so that the industry can catch up. But we can't go confiscate all our capital. There is just \$1.5 trillion in equity capital in the whole US banking industry. So it is very clear to me that the Treasury has to shoulder the load, but we have to start getting as tough as they are with GM. I think GM may be one of the turning points, but we'll see.

Rich Lashley: One of the things that has always kept me up at night is my little guys. My small- to mid-sized banks can't shoulder the load. There is no way they have the infrastructure or the capital to step into the void created by the big banks, much less step into the void created by the shadow banking market, securitization, asset-backed securities, commercial paper, and all the rest. There is still a financing hole that has to be filled in. I agree with Chris, the US Treasury and the Fed cannot fill in the funding hole ad infinitum.

Chris Whalen: But the good news, John, is that just as the little banks can't afford to pay the freight right now, they are our greatest allies; because what I think we need to do is have the government take the money we do have and attack these toxic assets, buy paper, which is part of their proposal now. But I don't want to sell it to the street immediately, I want to liquidate it. I want Sheila Bair to go into the Delaware Court and look at the judge and say, your honor I own 50% of Trust A-B-C, and I'm here to liquidate the trust and by the way the trustee has voluntarily vacated his office and – you know what I'm saying. Then you contribute all of those assets to the deposit insurance fund, you get legal custody of the loans, then you sell them to community bankers with financing, and they work it out. They talk to the client – what a novel concept. I'm sure Rich would appreciate that.

Rich Lashley: Yeah, we have to get back to the days when the lender and the borrower knew where each other were.

Chris Whalen: And we give them financing. As long as they use government financing, they have to service the loan. If they want to control the loan and do whatever they want with it, they have to come up with their own financing. I think that would work. It would take time, but we could piecemeal bid for all of this toxic stuff with collateral underneath. I'm not talking about the derivatives now. That's how you get rid of this problem; you got to liquidate it, John, because these deals will never come back. If you think about the buy-side constituents for these private-label deals, they are now maybe 5% of the original audience, because the rest of them can't look at it anymore. Their fund wouldn't even allow them to look at it. I am told, by the way, that Moody's and S&P are going to make a lot of money under the Geithner

plan, because he wants to rerate these securities and he's proposing to pay them for this. I find that astounding. After all they've done –

John Mauldin: I find that distasteful.

Chris Whalen: How can they do this? These companies ought to be under sanction and some kind of criminal investigation, but instead the Treasury is going to hand them a big pot of money to do the job they were supposed to do in the first place.

John Mauldin: That is just distasteful. I put them number one on my list of culprits. Greenspan only gets to be like 3 or 4. I think the rating agencies allowing their ratings for corporate bonds, the single-obligor bonds, to be used for multi-obligor bonds, based on a model that was provided by the investment banks and the mortgage companies...

Chris Whalen: And John, it's a very important point you are making, and let me illustrate. What was the rating agency doing when they were talking to the investment bank? They were operating in the primary market. They were structuring a brand-new Delaware corporation. Moody's advice as a banker helped to determine the structure of the entity's liabilities. They then offered securities to the market. This is what a banker does. And Moody's and S&P shared in commissions; they were acting as bankers. The significance of this is that in the secondary market, when they track a corporate – like you were saying, they are acting as a journalist. They are not sharing in commissions; they are not being paid on close. That's what they were doing in the primary market. I think they are in a lot of trouble, because that's different. I was a supervisor of bankers for many years. If you share in commissions you need to be a member of the FINRA, and they are not.

They were relying on the exemption in the 33 Act for their journalistic and ratings activities, but I don't think that's what they were doing when they were helping create a new firm that was going to go out and issue securities to the public, even if it was a private placement. They are still covered under the law.

John Mauldin: I absolutely agree, and I think that the stocks of the rating agencies could eventually go to zero.

Chris Whalen: Absolutely. They don't have the capital to be banks. They have don't have the insurance for this.

John Mauldin: They don't have the money, I think, at the end of the day to defend themselves from the legal liability that the lawyers are coming up with. If you are the chairman of Moody's and you are on the stand in front of the jury and the lawyers for the plaintiffs start hammering on you, you don't have any good answers. Well, we rated this because of X or Y or we used this or that; and he just comes back and says, wait a minute, you put these two paragraphs in a 300-page document that you put out. You sold a bond rating as something else; everybody understood what it was, and you have two paragraphs in there saying, no it's not, it's really different. On that stand, the jury is going to look at you and be outraged, and you are going to lose.

Chris Whalen: Keep in mind that Moody's and S&P were doing the same thing AIG was doing. They were renting people their credibility, and they were not cognizant of the risk. If they had been an investment bank and they had actually looked at the transactional risk with the liability and everything else in mind, I'm not sure they would have done these deals. But they were so intent on growing revenue that they ran

into the conference room with the bankers and the lawyers, operating on the primary market, and essentially created liability that I don't think they anticipated in their business models. I don't think they have the cover for it on the insurance side. I would almost bet you.

John Mauldin: I have seen internal emails from lower-level staff writing to upper-level staff, throwing up red flags, saying we can't do this, and the management came back and said, shut up, that's not what you are paid to do. Do this deal.

Chris Whalen: One classic example: My friend Sylvain Raynes, one of the great structured finance experts in this country, and his wife, Anne Rutledge, had to leave Moody's – two great professionals in that market. They couldn't stand it anymore, they couldn't work for the company anymore because of what was going on inside. They've told me this many times.

John Mauldin: This is going to be one of the great, shocking scandals of 2010 or 2011, because it is going to take awhile. It is going to take some time to get this into the courts. It is not like it is going to show up in two months. These guys will fight it forever, but it's eventually going to start showing up in court. I wouldn't want to be on the inside of the rating agencies. I think in 2015 – and Rich, you can comment on this – I think we have a whole new group of rating agencies; what do you think?

Rich Lashley: I just hope it's not a government agency. I hope it stays in the private sector; but at the end of the day it's going to end up in court and it's also going to end up in the regulatory environment. There will probably be some kind of political solution, and then Congress will decide whether the rating agencies will ever

die, because they do need them. The contradiction now is that, with this new program, you have to have securities that are still rated AAA. So we can't live without them, but they need to be punished for the sins of the past.

Chris Whalen: We need them, but we need to get rid of the monopoly. I want a strip-out of the statute, and I told Chairman Dodd this. Every point, whether it's ERISA or Section 12 for the banks, where we tell a bank or a financial investor that they must use an SEC-recognized rating agency, we've got to delete that provision and level the playing field so all the rating agencies, the cottage industry, the big guys can compete. Then people like Rich – his clients can pick who they want to use. I mean, we rate banks, but I would never bother getting recognized by the SEC. My clients see no value in it. But unfortunately for big-time asset managers, they are still forced to use the ratings of the big three for asset allocation, and that's wrong.

Rich Lashley: I kind of equate it to the accounting industry, which I worked for 13 years. You do an audit; you do the best you can. You don't go into it with fraud in mind. You may have conflicts – you are getting paid by the client – but you still do the best professional job you can; and if you make a mistake, you are culpable, you have a liability. But I am probably a little softer-hearted towards the rating agencies; I don't think they went into it with malicious intent.

Chris Whalen: I don't think they understood what they were doing.

Rich Lashley: They were in over their heads. But at the end of the day, should that be cause for putting them out of business? Or just confiscating their capital and making them pay a huge judgment, but at the end of

the day keeping them in business? Because did it do them any good to put Ernst & Young out of business? Did it do any good to only have four big accounting firms? Would it do any good to sue all of them and put them out of business? The country needs rating agencies, it needs accountants, and it needs lawyers.

John Mauldin: Let me clarify what I said, because I'm not saying we should put S&P or Moody's down like a favorite pet dog that's got old.

Chris Whalen: Because the equity holders are going to get hurt and go to zero, I agree with you.

John Mauldin: Yes, the equity holders are the ones that are going to lose, because the potential liabilities that I see from the lawsuits and the actions that the rating agencies have taken will overwhelm their capital; so they'll just go into bankruptcy and they'll emerge from bankruptcy. Someone else will buy them at some price because they have some economic value. The people that will own them will be the people involved in the lawsuit; and since they got all the capital they'll own the company, and they'll turn around and sell it for as much as they can get, whatever it is, and that will be done. We'll wipe our hands. So Moody's and S&P will exist, but they may not exist with the names they now have; they may be something else. AEGON could buy them, one of the big accounting firms could buy them. Someone will want to own them.

Chris Whalen: Well I will tell you something, John, there will be new firms. I have people constantly coming to me because we've built the IT piece of the ratings agency, in other words, the automation for doing the analytics. And

Moody's and S&P are so old-fashioned. They are so lacking in automation that a new player could absolutely decimate them. You could probably come in and have 60-70% or less of the SG&A cost of Moody's or S&P and go head to head with them, and they would have to match your cost because that's the only way they could survive. They are already cost-constrained now. They don't pay up for people. They don't pay a lot for data or analytics. It's a fairly low-tech operation. On the corporate side it's worked OK. Moody's and S&P do a decent job tracking secondary market bonds. They could do better. But the problem is the primary market. We've got to get them out of the banker's conference room, and then I think we can restore some sanity. They should want that, because it's only in the secondary market that they have the legal protection of journalistic privilege. When you are in the conference room you are a banker and you have no privilege. They've actually lost on procedural discovery issues on this exact point. If you get a judge in the Southern District of New York ruling on this as an evidentiary matter, or a matter of law, that's going to be a horrible thing for the whole ratings community. Because if we lose journalistic privilege, firms like mine, that's not a good thing. Even you, John, you have the same newsletter exemption that Moody's relies on to do all their secondary market research, and that is a thing we've got to keep. So Moody's has done us all a disservice, and S&P, too. They have really messed up a good model, which was, we are journalists. They crossed a line into banker land and that was a big, big mistake. Anyways, let's move on. What else do we have to talk about?

John Mauldin: Let's talk about the big banks and where the problems are. Rich, do you want to jump in? What do you see Citi,

Wells Fargo, B of A – what is your outlook for some of these specific banks?

Rich Lashley: Well again, I don't spend a lot of time digging through the financials of these bigger banks, but lately I've had to do some of it just because it has such a major impact on the whole industry. Generally speaking, the reason I think the big banks are in trouble today is they came into the cycle with virtually no capital. Unlike the little banks that we follow that came into the cycle with 6-8-10% capital, these guys came in with 1.5-2.5-3% capital. I was shocked back in August of 2007 when the news started hitting the fan. I went back and looked at Morgan Stanley and Goldman and all these big brokers and big banks and was just shocked. It really just kind of crept up on me how low they had taken their tangible capital ratios. So it's a case of having –

John Mauldin: That was a result of the Bush Administration allowing them, in 2002, to go to 30:1 capital. The five major banks walked in with all of these rocket scientists', mathematicians', and physicists' models and said here is why there is no risk and why we should be allowed to go to 30:1 leverage – because they had these smooth Gaussian curves, which is just obscene. We trained two entire generations of money managers at Wharton and Yale and Princeton and Berkley to believe in the efficient market theory of evaluating risk, all of this nonsense that you can model markets on some smooth wave, that we would model the average height of people or the average weight of people in a room. We've said it's the same, and it's just so blatantly not.

Rich Lashley: Yeah, the models only work when the markets are functioning. They don't when they're not. From a business-model standpoint, I'm sure every CEO of the big banks and brokers thought, boy, I

don't care if I have 2% capital, because if I get in trouble I'll just go to the market and overnight I'll raise a billion dollars. I could raise 5 billion dollars. I'll raise 10 billion dollars. I'll have five people in here begging to do the deal. Even when the credit crunch started, I remember one of the big pension plans – which I won't name here – was complaining that they were not allowed into the deals when they first started raising capital. So there was this feeling, and it was true at the time, that they could raise capital at the drop of a hat. So if you wanted to generate 15-25% ROE's, the only way to do that was lower the denominator. So you increase the leverage, increase the return on equity, and you can always replace that capital at the drop of a hat. And obviously that didn't work. We are now in a period where they need to raise their capital, but I still come back to, and I'm probably more optimistic than Chris, but I come back to even on the big banks that are in trouble, that their earnings power is still very significant. We are making these big banks the sole source of financial services in the world, not just this country. So they will be able to cherry pick their clients to get better terms, they'll divest businesses that aren't profitable, they will pick the ones that are the most profitable, and they will use their capital more judiciously. I personally think that they are going to do better on the stress test. Most of them will earn their way out of it. The government has already said they aren't going to fail, so basically we are just going to sit and watch as they churn and churn and churn and out the back tailpipe will go the exhaust, and I think they'll make it.

John Mauldin: Well they have a zero cost of capital and they're charging 6-7-8-percent; they ought to be able to make some money here.

Rich Lashley: It's kind of interesting. I actually talked to a senior economist at the Fed and I asked him, has the Fed ever done any studies or considered the fact that they may have lowered the Fed funds rate beyond the point of diminishing returns? In other words, when you go from one and a half down to a quarter, does that really help anybody? And I'll tell you, from a banker's standpoint, Fed funds at a quarter do not help. Because as Chris said, who wants to be a repo lender in this market? Lending out money at Libor plus 50, there is no money in that. So savers and lenders are being punished by rates being lowered too much. The value of a bank is to be able to borrow money cheaply. So when you can have a cost of funds on the bank level of 1.5-2% you don't want to have to compete with the Fed or Libor at 1% or .5%; there is no value in that. I've always said that the Fed should have stopped at a much higher number and allowed the banks to be the cheapest game in town, because right now they aren't the cheapest game in town. So the idea that they are borrowing money at zero and lending it out at 5 isn't really true. The margins are increasing, but not increasing that much. They are still stuck trying to get money in the door at 1 or 2, and lend it out at 5. So it's not quite as good as the Fed thinks it is, and I think they are pushing on a string a little bit by lowering the rates.

But that said, going back to the big banks, I think the earning power is tremendous. Sixty percent of the big banks in this country made money last year. Banks over 10 billion in assets. Even the ones that are struggling will I think earn more money, at least on a pre-tax basis, to offset the losses they have. I am really waiting with anticipation to see these first-quarter numbers. The Citigroup pre-announcement left a lot of questions in the air about whether those were pre-loss provisions, is it pre-tax, pre-mark-to-market

writedowns? I really want to see their numbers. I'll probably have a better opinion after I see Q1 numbers. I'm probably more optimistic than Chris about what the total cycle losses will be and their ability to offset them. In fact, I don't think, other than two or three of the bigger players, I don't see the conversions of preferred into common the way Citi did. At least not on a wholesale basis.

John Mauldin: Chris do you see any of the big banks failing or being nationalized?

Chris Whalen: Well I think they will be resolved; nationalization is only a temporary thing. It's what happens when the FDIC comes in and takes over the banks. The way I look at the larger institutions, I largely agree with Rich. I'm sitting here staring at our large bank spreadsheet, and most of the banks above 10 billion in assets in this country are fairly low-risk. The numbers kind of go like this: our worst-case maximum probable loss for the large banks is 1.7 trillion dollars, which is a very stressed scenario. But the top four account for 1.4 trillion of that. So what that means is that most of the rest of the banks in the large bank peer group are actually not contributing to that at all. Actually, they have such low risk that they would probably have a minus sign on their economic capital number as far as that list is concerned. I expect to see Citi resolved and broken up because I just don't think, despite the cash flow that Rich talked about – and it's true the industry does still turn out enormous cash flow – Citi doesn't have any room to increase provisions for loan losses, so the government is going to have to put more equity in there. That's the only way they can continue to absorb losses.

John Mauldin: How much equity are we going to have to put in?

Chris Whalen: Well, my economic capital number for Citi is 4.5 to 1, so for every dollar in current Tier 1 risk-based capital that the group's subsidiary banks have, the worst case is that you are going to basically need three times that to get through the cycle. That is both charge-offs and securities losses flowing through the income statement. JP is up there too, largely because of their OTC derivatives book. Remember, JP, Jamie Dimon bought his investors, his bond holders, a lot of time by getting the performance of the bank back up to where they weren't in the basement. JP was in the bottom, death aisle of the large bank peer group for years in terms of ROA and ROE. He has kept the operation pretty tight. Wells Fargo is not nearly as risky as the rest. They don't have the institutional exposure and the structured finance exposure, but they have to work through Wachovia. Obviously it was written down to fair value when the purchase occurred. But what I have been hearing in the channels is that Wells is basically focused on Wachovia, and they are not really dealing with a lot of their own issues prior to the merger. I think the government will have to put more money in there to help them absorb the losses on Wachovia. Then you get to Bank of America, which started 2008 as probably the most stable large bank, along with Wells; and the Merrill transaction to me is still a question mark. I am kind of with Rich. I want to see the Q1 numbers and how they are spinning this. But bottom line is, I am still not sure we are done remediating Merrill. I hope we are, but they were the biggest CDO shop and they had all sorts of structured exposure, so I have to wait and see what the thing looks like over time. Now of interest, Goldman is another firm that has a very high economic capital number compared to their current Tier 1 risk base. You are going to see both Goldman and

Morgan Stanley restructuring themselves such that most of their institutional business will be coming out of a bank instead of a broker/dealer in the future. As Goldman gets their operations conformed with the Fed regulations and the Bank Holding Company Act, I think they are going to have to reduce the risk profile of their business; because they stick out like a sore thumb, and other people can see the same numbers I'm looking at. The RMBS footings, the non-high-quality risk that is very evident on Goldman's books is not a great source of comfort for me. I think the large dealers who have exposure to structured finance, who have exposure to entities like AIG, are still in a lot of trouble. But the good news is, the rest of the large bank peer group, other than some obvious exceptions, is in reasonably decent shape. We'll just have to see what the loss rates look like as we go through the year and how long we stay at peak loss rates. If we peak and go back down again, that's good. But if we get up to maybe – I'll give you some numbers. In 1991, the industry peaked at about 2% charge-offs, [is that right] Rich?

Rich Lashley: Actually, 1.34 in 1991.

Chris Whalen: Alright. Then Citi – I looked at Citibank, N.A., and they peaked at about 3% charge-offs in 1991, and the bank almost failed. I think they could do a lot more than that this cycle.

Rich Lashley: What has been taken so far, about 4%?

Chris Whalen: Not quite. If you just look at the banks, if you look at the parent level, they are up there. That's really my concern. Citi has always been less efficient than the other large banks because of its foreign banking operations. They are very labor-intensive, very high-cost; so they took more

risk to compensate. You can see that. They get paid more for the loans, they have a much higher yield on their book, they take risk over a much shorter period of time than most banks. The wham on Citi's bank subsidiaries is only about 4 years. But having said all that, they are now the leading edge. They are the outlier in the large bank peer group, so I anticipate that Citi is going to have to be resolved. But they've probably bought themselves a quarter with this accounting rule change. I think that was the intent, by the way. Everyone is trying to buy time.

John Mauldin: I've been writing about that for a long time. I think that is what the Fed and Treasury are doing. They are going back to what Volker did in 1980 by allowing the banks to keep the Latin American loans on their books at original loan value rather than writing them down as mark-to-market. They bought the banks 7 or 8 years, because technically every major bank in the country was bankrupt. I think we are in that same process now; we are just trying to buy time. It stretches out a problem. It creates lack of capital, but for some of the banks that time will get them there. Now I want to circle back...

Rich Lashley: Actually John, I just want to make one more point about the big banks and the rest. The one thing that your listeners and readers should understand is that we are clearly in a period where capital has to be rebuilt. So investors in banks who are looking for dividends, they really have to put that aside for a couple of years. The big banks are not going to be able to pay big dividends, because of the regulators. You have to remember, these banks are two entities. They have a holding company; that's the public company. Then there are the bank subsidiaries. The regulators put a big line between the two. So the ability of

the public company, the holding company, to pay dividends to shareholders is predicated on the earnings power and the dividend-paying capacity of the bank subsidiary. The regulators have cut that off. So you are not going to see, either by choice or the force of regulation, you are not going to see very many banks paying big dividends, because that is the source of rebuilding capital.

Chris Whalen: Indeed John, the whole industry – if I were an FDIC, I would go to Congress and say, look, the industry will retain capital for the next 18-24 months and the Treasury will pick up the financing costs of resolutions. I think that makes sense because, as Rich says, the investors are going to be taking the pain, they aren't going to see any cash flow off these equities securities. We have to get them healthy.

Rich Lashley: The only question is, at 30% of book or 50 percent of book, can you live without two or three years worth of dividends? I say yes, but people should not expect those dividends to be paid.

Chris Whalen: I agree with Rich. When a holding company is deprived of income from its subsidiary's banks, it can only last so long. Most holding companies don't have significant non-bank assets, so they basically starve to death.

Rich Lashley: The thing that will be interesting to see, which has never happened before, is that I think we are going to get into a cycle where we may have holding companies go bankrupt and the bank subsidiaries, which are relatively healthy, stay in business. You might get new owners...

Chris Whalen: Exactly. MCorp. MCorp had what, five banks seized? The parent was

in bankruptcy but the banks continued to operate. I think, much like GM, the solution with Citi may be to put the parent into bankruptcy, convert the debt to equity, and work it out.

Rich Lashley: Right, which is not an FDIC failure in the classic sense.

Chris Whalen: No. And I think if they did it overtly and said look, we are going to go restructure the parent, we are going to give the bond holders a little optionality on the future, but they have to convert; I think that is a very sane way of approaching this, because all of a sudden Citi has 50% tangible common equity.

Rich Lashley: Exactly, and I think the bond holders, most of them, would want to participate in that rather than see failure. Now they didn't have time to do it, but they should have done that with Washington Mutual, because they had a deep-pocket private equity investor who probably would have put in more money. The holding company could have been restructured, they could have saved the bank, but instead they panicked and pushed it out the door over a weekend. I think now that we've had more time to take a breath, everybody should relax and perhaps give restructuring a chance without resolving the banks and closing them down and costing the taxpayers money. Let the private sector work this out.

John Mauldin: We may be getting there, because the revulsion factor, if you will, on the part of taxpayers and even Congress, in terms of coming to the well and coming to the well – another 200 billion, another 300 billion. Let's circle back here. The destruction of capital, the destruction of leverage we are seeing is just on an unprecedented scale worldwide, and this is just massively deflationary. It's hard for

people to understand, but we are just reducing the amount of money, because there are two forms of money. There is actual physical cash, roughly 2 trillion bucks on the Fed's books, and then there is credit, which was roughly 50 trillion. As a practical matter, as businessmen, as individuals, we work on credit. We don't pay cash for everything. We use our credit card, we write a check, we do whatever. So we have this monster money supply that includes credit, and we are reducing that credit money supply faster than the Fed can print, and it's just massively deflationary. I think the Fed saying they are going to print 300 billion and they are going to buy another 300-400 billion of GSE debt is just the beginning. They are going to be coming back to the well for another 300 billion and another 300 billion and they are going to have to have more money for Citi. I think at some point the public is just going to throw their hands up and say, how much more can we bail these guys out for? And they are going to start having to let some of them fail.

Chris Whalen: Exactly, and I think that's why Rich's suggestion is very constructive, because there is no more money coming out of the Senate until they see a change in policy. It's interesting, because you may have seen Barney Frank and Chris Dodd put out a little love note yesterday on how they are going to cooperate on regulatory reform? There are no votes in the Senate to even preserve the Fed's role in bank supervision. I think most of the members of the Senate Banking Committee would strip the Fed of all of its responsibilities for banks tomorrow, that's how disgusted they are. The large part of that is that they believe the Fed and the other agencies have not been telling them the truth. I think the public agrees with that perspective. So until these people start speaking the truth in public, such that we say, yes, that's a reasonable

proposal, I don't think they are going to get anywhere.

John Mauldin: I'm jumping in on you, but that's what I was writing about. I don't think Bernanke and Geithner and Paulson before him, if they came in and said what they really thought, I think the market would just absolutely panic. There are one of two conclusions: either they didn't know, which is a really bad situation, that they were that naive, because if you are looking at the numbers and can't figure it out, that's bad. Or they are just simply saying – the old line from the movie – “You can't *handle* the truth,” and that's what they are basically telling us and Congress.

Chris Whalen: Well I'll tell you one thing, John, if the Treasury tries to fund all these novel ideas of the Fed, the Senate is going to remove Ben Bernanke, because they are just not going to stand for it. The anger in this country over what they see and the debasement of the currency, the complete destruction of the Fed as an independent agency, I don't think it's going to stand. I can't wait 'til next year's election; I gotta tell you, I think a year from November we are going to see incumbents slaughtered in large numbers. Democrats have already told Chris Dodd –

John Mauldin: Well that would be a useful thing, to replace those empty suits up there.

Rich Lashley: I guess I am a contrarian at heart, even though I am generally pessimistic; I usually look for the dark side. But I am a contrarian, and I look at valuations on bank stocks and I think we've more than discounted the problems, particularly for smaller banks. So we are as fully invested as we've ever been in the 13 years I've been doing this. I think it makes sense to own some bank stocks. I think the

sector will survive. I think the big banks are trading like options; so if you're a speculative investor, you can probably wade into a Fifth Third at \$2 or a Bank of America or Citigroup as an option, and how it plays out is unknown. On the big bank side, if you really want to make a better investment, I would look at the cumulative trust preferreds, which, as we've seen through this cycle, tend to be left alone. Those will not be converted into common equity, so you won't get diluted out. I think they will survive, and they have to pay you eventually. That's a better investment, with the 4-1 upside, plus you get paid while you wait; and even if they defer dividends, you'll eventually get your money back. On the small banks, I think it's time to step into the equities, and we all need to just relax, take some time. Let the industry recover, let the economy recover. If we can just turn off and put a moat around Washington – turn their phones off and turn the TV off, we would probably all be better off. I go back to the RTC days, where the cycle took about seven years to play out, and it played out in seven years because we didn't have CNBC on 24/7. So people didn't panic, the regulators didn't panic, the politicians didn't panic. It happened on an economic basis. So I think everything has been compressed on the negative side of it. We are taking five years of problems and putting them into two years. The flip side, that probably means we will recover sooner. So I am cautiously optimistic that it will resolve itself favorably.

John Mauldin: Let me ask you a question. You talked about cumulative preferreds; tell us what that is.

Rich Lashley: Trust preferreds, which legally in the debt structure are a little better than straight preferreds. Straight preferred stock is typically noncumulative, which

means they don't have to pay the dividend if they don't want to, and they don't have to cumulate prior past dividends that they did not pay. A cumulative preferred is one where if they defer dividends for a quarter or two or a year, they have to eventually pay those off if they want to catch up. In other words, if they ever want to pay another common dividend again, they have to pay off the arrearages on the cumulative trust preferred. They are also considered subordinated debt in the capital structure, so if you go back for example to when Citi was trying to buy Wachovia, they were going to assume the trust preferreds but not the other preferreds, because it was a debt instrument and they knew they had to pay the "credit" even though they were leaving the equity behind. So it is more like a debt instrument than an equity instrument. It's the place to play. These are all trading at 15-50 cents on the dollar. It's a nice way to play the investments in the big banks without having to worry about the capital dilution for the common.

John Mauldin: Have you got a trust preferred that you like?

Rich Lashley: We own a bunch. The old NatCity, which is now part of PNC; they have some out there. Bank of America, the Countrywide preferreds are out there, but they are really Bank of America guaranteed. I guess the Merrills; there are some trust preferreds out there whose obligations have not been expressly taken on by Bank of America, but they will be.

Chris Whalen: Ken is still playing his little game isn't he?

Rich Lashley: Yeah. And those trade at a discount, because they have a different symbol. So like PNC, you can buy the NatCity C's, NCCC, preferred C, and it

trades at a couple-point discount to the PNC direct trust preferreds, for example. PNH is the symbol; and it has a higher coupon and trades at a discount. You are talking about current yields at 15-30 percent.

John Mauldin: Really?

Rich Lashley: Yes.

John Mauldin: Well, good. The listeners get some good specific advice on that. Chris, what have you got?

Chris Whalen: Well I somewhat agree with Rich, but I'm a little more cautious. What I've been telling my clients is that if they want to go shopping, they should focus on banks that are well below the top 30 and look for institutions that have relatively high-quality assets and earnings. In other words they may still be making money. Also that have relatively low equity volatility compared to the big guys, because I think the market is often right. What Rich is saying about preferreds and some of the quality institutions is borne out by the market – people are doing the work. So when you see an institution that is demonstratively different in terms of business model, has a lower equity volatility, and may still be trading at .4 or .5 times book compared to the big guys, that's a situation where I wouldn't mind seeing people get involved in the equity, or maybe the preferreds would be the starting point. But for complex institutions, Fifth Third for example, I'm not comfortable encouraging anyone to get into those, because I think there is a chance they will have to be resolved or merged with government assistance. Huntington is another one, a great bank, but right now it's getting clobbered. So you can look at the US Bancorps if you have a really high tolerance for risk, but remember, if the macro

environment continues to deteriorate, and we see charge-offs and losses continue to track higher this year, even good banks are going to have a tough time. So I agree that there is value out there in the smaller names; but I am very selective, and frankly, the clients I have that are the most comfortable getting involved are basically the vultures. These are the guys who are going to buy restructured banks from the FDIC, who are going to buy assets that have been marked down and restructured. I think they are going to be the ones that are really going to be hitting the ball out of the park, at least right now. The public story is going to have great legs. I agree with the magnitude of the upside that Rich has described, but I'm still kind of cautious with the big guys. So anybody in the top 20 or 30, I would leave alone for now.

Rich Lashley: Very clearly, I agree with Chris. There will be some great fortunes made by a handful of people in this cycle, just like there were in the RTC cycle.

Chris Whalen: That's right, they are doing the work and are taking the risk, so they ought to get paid. Thank you, John.

John Mauldin: Thank you guys for taking time to be with us. And Chris, I look forward to fishing with you in Maine.

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