



Smith Affiliated Capital

880 Third Avenue, New York, NY 10022 -TEL: 212-644-9440 -FAX: 212-644-1979 - www.smithcapital.com - info@smithcapital.com

February 2002

ACCOUNTING FAILURES AND ASBESTOS: THE GENESIS OF A SERIAL CREDIT IMPLOSION

The scandalous cozy reporting of business risk and the recording of its financial impact has laid bare serious over-statements of corporate profit in the month of January. What began with Argentine and Japanese devaluation and defaults, the bankruptcies of Enron, Global Crossing, Kmart and McLeod USA, the accounting irregularities of Tyco, Anadarko, Williams Co's., and PNC Financial Services Group now has reached new levels of consideration (i.e., fraudulent activity). This has become a watershed development for American business, for as the fundamentals of the accounting profession are being questioned, so the communication of corporate information is being challenged for its differential and discriminating quality of delivery. The upcoming reactive change toward more conservative accounting will mean a much-reduced level of corporate profits going forward and, in and of itself, will cause enough pressure to snuff out any incipient recovery.

The corporate culture of excessive management reward that is myopically focused on the bottom line has abused shareholders, bond holders, customers, creditors, and employees as all manners of short-term expedience and deceit in reported profits have been blindly tolerated. This is truly one of the big excesses of the financial markets now being corrected, albeit at a huge cost. The correction vigilantes are the legal community who, in their chase for fees, are clearly attacking the financial, energy, and industrial sectors of the corporate world.

The accounting excesses are impacting mostly big-“cap” companies as opposed to mid- and small-“cap.” While the latter two are deemed more interesting, they are inherently riskier and any increase in asset allocation to these sectors should be offset with additional fixed income.

The legal community is driving two different challenges to the corporate world. First, there is the question of fraud in the Enron bankruptcy case, which removes insurance coverage, thereby leaving little opportunity for recovery. However, the legal community has identified limited partners in the Enron partnerships as recipients of preferential information over shareholders – and, therefore, considers them “insiders,” eligible to be listed as defendants in the shareholders’ attempt to achieve some recoupment of their investments. Should this be legally formalized, it will have a significant impact on the financial markets and the corporate bond sector in particular.

Complicating the situation, however, are conflicting regulatory guidelines, passed by Congress, that govern the disclosure of “insider” information: Regulation FD and what remains of the original Glass-Steagall. Financial markets should expect protracted congressional and media attention, with substantial real and opportunity costs, resulting in a labyrinth of overlaid onerous regulations with limited impact, other than huge cost, if history has its way.

Secondly, with regard to the latest developments in the asbestos eruptions, nine companies that mined the material or manufactured asbestos products have fallen to date, and new candidates are surfacing such as Halliburton, Dow Chemical, and Minnesota Mining – and there are many more. Again, the impetus is the army of asbestos attorneys that have expended time, money, and effort to win legal victories and receive large monetary awards from the courts. However, these attorneys have realized only token payments from their successful class action

suits against companies that mined or manufactured asbestos as bankruptcies have seriously reduced their ability to collect more than minimal amounts. These attorneys have now turned their attention to companies that distributed or installed asbestos, or parts made from asbestos, such as brake pads or fire walls. Included in the class action universe are producers, installers, maintenance personnel, and/or users of these items – an exponential expansion of targets across all industrial sectors.

While this subject has not received the “sensationalization” of television headlines, the potential for broad impact in the corporate world is far greater than an isolated event. Attorneys are looking for a return on their sizeable investments from structuring their class action efforts and have refined the “stalk and chase” of their quarry through numerous proceedings. This well-oiled approach is accentuated by the court-tested fact that asbestos is the only known cause of a debilitating disease that can have a half-life of twenty years before symptoms are manifest.

The structural weakness in corporate health that is being revealed by the serial wave of corporate bankruptcies and accounting manipulation indicate further growing problems for the economy and the stock market. While these conditions have been virtually ignored until recently, passive index investing has suffered major damage as an institutional strategy because of its inability to avoid these disasters. More importantly, there is trouble ahead for many financial services companies – such as banks, insurance companies, and investment-banking concerns – that carry structured financing instruments from commodity and derivatives trading on their balance sheets. In support of this point, on the morning of January 29, 2002 – the same day that the Federal Reserve held rates steady – the Federal Deposit Insurance Corp. dropped the amount of capital that banks are required to keep in reserve for loans to Wall Street brokerage firms. Banks will now be required to hold only 20% in capital funds in reserve for loans to securities firms, down from the current 100% obligations. This regulatory move was worth more than three rate cuts to the financial markets.

This serial crisis environment is presenting a golden opportunity to re-focus on the benefits of quality fixed income management. Historically, the fixed-income markets have had insight into the problems of the financial markets long before the equity markets do, and this continues to be the case. In all of the bankruptcy situations, the individual company bonds sold off much earlier and deeper than did the respective equity prices. This risk-averse nature of quality fixed-income management runs counter to the thinking of opportunistic gains or enhanced returns in either the equity or high yield markets, but quietly offers stability and predictability in ambiguous times — even over indexing, which cannot avoid its share of credit issues. The rise to the fore of quality fixed income, which has avoided these problems, has been our continuing story as we reach the high-water mark of our twentieth anniversary as a firm.

In the face of near- to mid-term market uncertainty, driven by such issues as accounting concerns and asbestos, we believe that flight-to-quality asset reallocations favoring fixed income will outperform heavily invested equity, global, and even index portfolios on any risk/return measurement for the remainder of this year.

Smith Affiliated Capital Corp. (SAC) is a registered investment advisory firm based in New York. The firm was founded in 1982 to design and implement fixed-income strategies for institutional and individual clients. It specializes in the active management of high quality taxable and tax-exempt portfolios for either total-return or liability-specific needs.

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Robert G. Smith, Ph.D., Chairman

Charles C. Hubbard, President

Maria E. Smith-Breslin, Executive Vice President/Director of Marketing & Client Services