

BROOKMONT CAPITAL MANAGEMENT

“A BUGG’S LIFE”

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November 14, 2007

Mortgage Mayhem

A lot has transpired over the past few months and there is a lot of ground to cover. But I first want to say “thank you” to everyone who has helped launch Brookmont Capital Management and we appreciate everyone’s support and confidence. We look forward to building an investment firm that is based upon client service, high-quality investment management, and long-term relationships.

Since we last talked, the meltdown in the sub-prime mortgage sector has dominated Wall Street and the headlines of newspapers from coast-to-coast. I am not going to address the complexities of how individual mortgages are packaged and sold to investors around the globe. What I do want to address is how we got into this mess and why the blame lies more at the doorsteps of the White House, the Federal Reserve, and mortgage companies and not with most homeowners.

Think back to 2002 and what was happening at the time. The stock markets were suffering from their third straight year of negative returns, the US economy was struggling to get back on its feet, and interest rates were close to an all-time low. The Federal Reserve was pumping money into the U.S. economy and credit was easy to find. The one-month LIBOR stood at an all-time low of 1.40% and a new type of mortgage products were based on this benchmark.

At the same time, the White House was embarking on a major PR campaign that encouraged all Americans to become homeowners. Mortgage companies were popping up everywhere and staffed their offices with inexperienced mortgage lenders. Americans were blessed with Greenspan, Bush, and Countrywide Mortgage singing the praises of owning real estate. To top things off, realtors were telling their clients that owning a home was a much better investment than stocks. With the markets almost 40% below all-time highs, it was an easy sell for everyone.

And Americans ate it up. Homes and condos were being flipped over and over, new construction went through the roof (excuse the pun), and 60 minute infomercials on TV



praised this new way to personal fortune. As home prices soared in many parts of the U.S., the mania began to spread throughout small towns and big cities from coast to coast. And then Greenspan made comments about the mortgage industry in 2004 that have come back to haunt thousands of American homeowners. In his report to the Federal Reserve, Greenspan said history had proven that adjustable rate mortgages were a better option than the traditional 30-year fixed loan.

“Indeed, recent research within the Federal Reserve suggests that many homeowners might have saved tens of thousands of dollars had they held adjustable-rate mortgages rather than fixed-rate mortgages during the past decade, though this would not have been the case, of course, had interest rates trended sharply upward.”

“To the degree that households are driven by fears of payment shocks but are willing to manage their own interest rate risks, the traditional fixed-rate mortgage may be an expensive method of financing a home” (Chairman Greenspan, Feb. 23, 2004).

His analysis was faulty for several reasons. For starters, his study only included a ten-year history. Second, it came during a time when the Fed was actively reducing short-term interest rates. For example, many adjustable-rate mortgages are based on a 3-month Treasury bill, which saw its average yield fall from 6% in 1995 to 0.85% in 2004. In comparison, a 30-year mortgage is based on the yield of a ten-year Treasury Note, where the average yield declined from 7.8% in 1995 to 4.25% in 2004. The sharp-decline in short-term rates explains the outperformance of ARM’s.

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Not only did mortgage lenders run with Greenspan's comments, they developed new loan products that were hyped for their very low introductory interest rates. Unsuspecting home buyers were given the heavy sell for these loans by untrained and inexperienced mortgage lenders. And since this happened during a time when interest rates were near all-time lows, it was a time bomb just waiting to explode.

For several years, the mania in real estate paid off. Home prices continued to rise, and homeowners used their built-up equity to take out second mortgages. This cash flow helped many Americans live well beyond their means, and many became very comfortable in their new lifestyles. As home prices and housing demand both moved higher, home builders teamed with outside investors to ramp up construction of condo buildings and spec homes.

While this mania continued to build, anyone who even whispered a warning about overinflated real estate prices was shouted out by mortgage companies, realtors, builders, and their friends. While it is not the Federal Reserve's responsibility to regulate the wisdom of American consumers, it is their job to keep price inflation in-check and to prevent a meltdown in asset-based sectors of the economy. This is where the Fed dropped the ball.

In 2006, everything in the housing market began to unwind. Homeowners watched their adjustable-rate mortgages jump a full two percentage points every year. Many were unable to do anything to stop the hemorrhaging as they were stuck in mortgages that carried huge pre-payment penalties. However, most could still qualify for a home-equity loan, which was used to pay the higher monthly payments on their

primary mortgage. Since everyone assumed real estate prices would continue to rise at double-digit rates, lenders continued to approve these loans and homeowners continued to borrow.

Just as investors learned in 2000 that stock prices do not go to the moon, homeowners began to learn this lesson in 2006 as home prices reached a plateau. As mortgage payments were adjusted higher once again, there was no excess equity for homeowners to borrow against and many of them had maxed out their debt levels. As their outlet for cash flow came to an end, mortgage payments were being missed across the country. The end result was a major uptick in foreclosures and lenders were left holding worthless mortgage loans and unwanted real estate property.

It is easy to see how this snow-balled on homeowners nationwide. For example, many mortgages that originated in 2003 were either interest-only or "pay-option" loans. These loans often included teaser-rates of 3.50% or lower for the first few months, but would adjust on a monthly basis in the near future. With an initial interest rate of 3.50%, a new homeowner with a \$200,000 mortgage would have a monthly payment of about \$898.

Since most of these mortgages included a three-year prepayment penalty, the homeowner would have this same mortgage product going into 2007. However,

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Sector Returns as of November 12, 2007

<u>Sector</u>	<u>MTD</u>	<u>QTD</u>	<u>YTD</u>
Energy	-6.83%	-5.87%	19.74%
Materials	-8.53%	-4.87%	14.64%
Industrials	-5.49%	-6.04%	8.77%
Consumer Discretionary	-7.75%	-7.74%	-11.69%
Consumer Staples	-1.85%	-0.22%	7.84%
Health Care	-3.05%	-1.25%	4.55%
Financials	-10.03%	-11.83%	-17.85%
Information Technology	-11.03%	-4.68%	10.22%
Telecommunications Services	-6.91%	-8.28%	5.60%
Utilities	-3.23%	3.17%	11.92%
S&P 500	-7.02%	-5.54%	3.08%

Mortgage Mayhem (cont.)

the interest rate on the mortgage has increased from 3.50% to 8.50%. When you consider that many of these same homeowners have taken equity out of their homes during the past few years, their monthly payment has now risen from \$898 to \$1,751 (nearly a 100% increase since 2003). The homeowner no longer has equity in the home to bail him out, his salary has only risen 4% each year, and comes during a time when his monthly outlays for gasoline and utility bills have soared.

Mortgage lenders were then forced to write-off loan portfolios, write-down the value of foreclosed properties, and eventually scale back their operations as demand for new loans dried up. Many finance companies abandoned the mortgage business altogether. While home buyers can still find mortgage companies willing to lend, to qualify for a loan requires a very good credit history, meet tighter Fannie Mae regulations, and include at least a 5% down payment.

In the end, the Federal Reserve is once again coming to the rescue of Wall Street with its successive cuts in short-term interest rates. This was obvious when the Fed cut the Discount Rate (and not the Fed Funds Rate) by ½ point in August. We saw the same thing happen after the implosion of Long-Term Capital, the steep decline of technology stocks, and other self induced crisis on Wall Street.

Greenspan has gone on record that he did not foresee the risks that were building in the sub-prime sector and it was not until 2006 that he had a grasp of what was happening. These comments do not give investor’s much confidence in the Fed’s actions, and demonstrates a Federal Reserve that is reactionary and out of touch with the everyday life of most Americans.

In the end, experts believe 2 million homes will be foreclosed before the sub-prime mortgage debacle is over. Investment property has been the primary victim so far. First-time homebuyers will be the next sector to get hit. This crisis is far from being over.

Market Update

Needless to say, it has been a rough two weeks for the stock market. Hampered by the sub-prime mortgage debacle for the past several months, stocks are also facing headwinds from rising oil prices, weaker corporate earnings, and warnings

Index Returns as of Nov. 12			
Index	November	Year-to-Date	One Year
S&P 500	-7.02%	3.08%	5.47%
S&P Mid-Cap	-6.59%	5.50%	6.90%
S&P Small-Cap	-7.35%	-0.08%	.09%
Dow Jones	-6.79%	4.20%	7.10%
NASDAQ	-9.76%	7.00%	7.40%
EAFE (Intern’l)	-5.32%	9.02%	14.31%

about the economy. It takes a lot of conviction and patience to buy into this type of environment.

Then again, if buying into the market was always a risk-free endeavor, everyone would be an investor. But that isn’t the case. So while we do not recommend aggressively buying new positions in today’s market, we would suggest selectively adding to current portfolio positions, or buying equities that will weather the headwinds mentioned above.

There have been few places to hide from the market’s decline this month, but there are certain areas of the market that have been severely hammered. The Financial sector has taken the brunt of the decline since October 1, led by continued warnings in the banking sector. Analysts are raising concerns that certain companies will be forced to reduce their quarterly dividends, and we may see several companies weakened to the point where they need a white knight to come to their rescue.

It should come as no surprise that the technology sector (and the NASDAQ) was hit hard during the market’s decline this week. The technology sector had gone through much of the credit meltdown unscathed and names like Cisco, HP, Google, and Apple were trading at 52-week highs. But investors seemed to finally understand that the largest buyers of technology equipment include banks, brokerage firms, mortgage companies, etc. Anyone who has worked in the banking industry knows that technology spending is the first discretionary budget item to be cut during periods of earnings pressure. Cisco Systems was the first to warn about this risk to future sales growth and you can expect that many other companies will follow suit. The one saving grace is that consumers delayed buying new PC’s in the fourth-quarter of 2006 with the anticipated launch of Microsoft’s Vista operating system. While that will make fourth quarter earnings comparisons easy to beat, the first quarter of 2008 will be a different story.

Market Predictions

By now, every newsstand should be filled with financial magazines touting their market predictions for 2008. To sell as many copies as possible, the cover headlines will do whatever it takes to grab your attention. Although no one can predict with any great certainty what will occur over the next twelve months, it is necessary to make forecasts about the future even without the help of a crystal ball. That said, here was my prediction for 2007 that I wrote at the beginning of the year:

Turning to the markets, I believe that Large-cap stocks will begin to outperform as the decline in the U.S. dollar allows them to leverage their multi-national operations. Large-cap stocks also offer investors a defensive play as earnings growth declines to single digits. While opportunities still exist in small and mid-cap stocks, they have enjoyed four years of steady outperformance and valuations are no longer below historic averages. I continue to see international markets as an attractive addition to portfolios as many foreign countries are witnessing faster economic growth than the U.S."

"While earnings growth is forecasted to decline, I believe 2007 will bring the continuation of several market drivers that helped push stock prices higher during the previous year. I expect to see another banner year for mergers and acquisitions, fueled by private equity firms, international corporations, and from public companies that have a sizable position in cash. Stocks should also benefit from increased fund flows as investors shy away from the real estate market."

How good were my predictions? According to Standard and Poor's, the large-cap sector of the market performed very well in 2007 as the largest stocks in the S&P 500 outperformed the rest of the Index. Small-cap stocks have underperformed the general markets for the first time since 2000. The international sector continues to show double-digit gains with the Lipper International

Median up 16% year-to-date, and the Lipper Emerging Markets has risen 36% this year.

In our next newsletter, we will look into the crystal ball once again and offer our outlook for the markets and the economy in 2008. The most important variables next year will include the Presidential elections, corporate earnings, and the outlook for the debt markets. Sounds like a rewind back to 2004, 2000, 1996, etc.

New Highs/New Lows

Stocks that have hit their 52-week high or low include a wide variety of names and industries. However, almost 1,600 stocks have reached their 52-week low, versus 419 at one-year highs. Reaching one-year highs include technology stocks Google, Apple, and Hewlett-Packard; energy names Apache, Occidental, and Transocean; consumer goods companies like Diageo and McDonald's; plus industrial companies like Deere and General Dynamics.

Stocks that are sitting at 52-week lows make up a diverse group of names: Coach, Citigroup, Capital One, Family Dollar, Home Depot and Lowe's, Eli Lilly, Pfizer, Nordstrom, and Starbucks. In fact, the majority of stocks trading at a one-year low are retailers, Real Estate Investment Trusts, banks, and housing related companies. More than 50 retail chains and suppliers are trading at their low, which does not indicate a strong holiday shopping season is in our future.

Japan, Inc.

Toyota surpassed GM this year to become the world's largest auto producer. Toyota will win another distinction in 2007 as it sells the most passenger cars in the U.S. for the first time ever. Ford has fallen behind Honda and Nissan isn't too far behind.

Sales of Passenger Cars in the U.S.				
	<u>Oct-07</u>	<u>Oct-06</u>	<u>YTD 2007</u>	<u>YTD 2006</u>
General Motors	109,779	109,896	1,243,909	1,356,658
Ford	55,812	76,419	643,813	884,665
Chrysler	36,115	31,379	433,749	415,762
Toyota	110,753	107,328	1,278,763	1,225,400
Honda	66,015	57,835	743,794	722,841
Nissan	47,812	38,330	536,473	458,482

Welcome to Brookmont Capital Management

We are happy to bring you our first edition of “A Bugg’s Life” and also introduce Brookmont Capital Management. We are a Registered Investment Advisory Firm based in Dallas, Texas and offer investment management services for families, individuals, Foundations, and corporations. Our investment services include customized portfolio management, utilizing an asset allocation mix based on your goals and objectives. We focus on individual equities and fixed income securities for the core of our portfolios, and select certain Electronic Traded Funds (ETF’s) for enhanced diversification.

We have selected Texas Capital Bank as our provider of custodial services. Their Wealth Management Department can offer Trust Services to our clients, which allows Brookmont to manage investment portfolios within every type of fiduciary account. As well, Texas Capital offers nationally-recognized expertise in IRA regulations. Brookmont clients will benefit from Texas Capital’s wide offering in deposit accounts, loan products, and other banking services. Our relationship with Texas Capital also provides our clients with the peace of mind knowing that our assets are held by one of the country’s highest quality banks.

Brookmont Capital and Texas Capital Bank are both located at 2100 McKinney Avenue in the Uptown area in Dallas.

Why a Tree?

You’ll notice that our new logo includes a tree, but it’s not just any ole tree. Although “Brook” and a tree would seem to be our play on the environment, that’s not the reason for its prominent position in our logo. The tree is actually a Buttonwood Tree (aka American Sycamore). In 1792, twenty-four brokers met under a Buttonwood on Wall Street in New York and signed the “Buttonwood Agreement.” This agreement basically launched what we call today the New York Stock Exchange.

DISCLOSURE

The articles and opinions in this publication are for general information only, are subject to change, and are not intended to provide specific investment, legal, tax or other advice or recommendations for any individual. We suggest that you consult your attorney, accountant or tax or financial advisor with regard to your individual situation. Although information has been obtained from sources Brookmont believes to be reliable, we do not guarantee its accuracy and it may be incomplete or condensed. Brookmont is not liable for any typographical errors or incorrect data obtained from reliable sources of factual information.

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