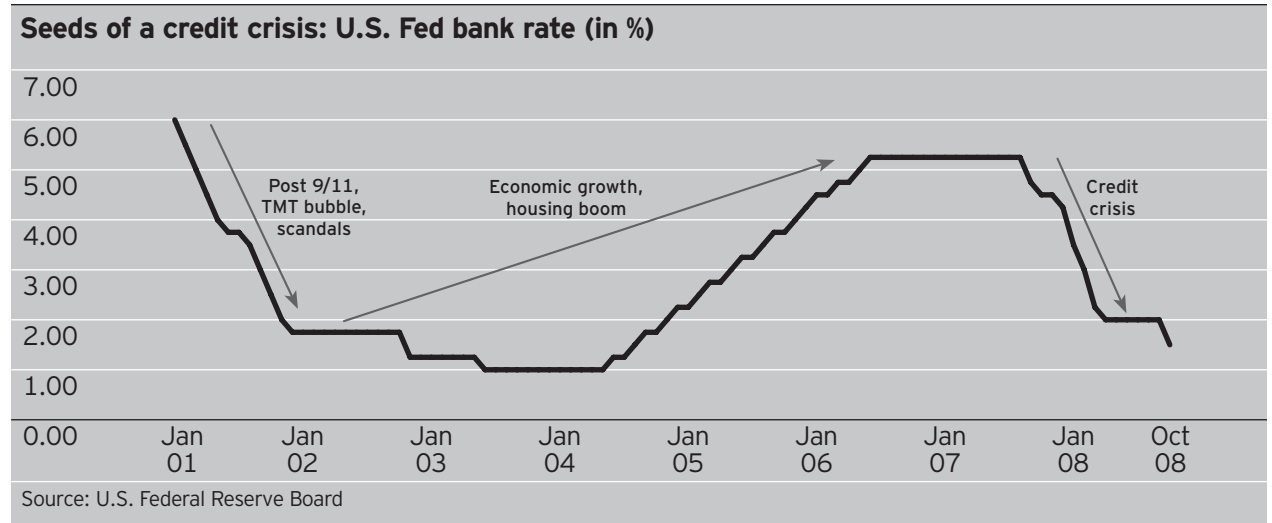


Putting the financial crisis into perspective

In these turbulent times, investors are questioning what to do with their investments. Clearly, panic selling is rampant, but many view this as a buying opportunity. While that may be so, there should be a very big caveat attached. Investors should consider the services of a true active professional money manager. Otherwise, investors risk resuscitating the herd mentality that is the single biggest contributor to creating this and every other asset bubble/bust.

2001-2006: The boom time



- Investors witness the implosion of the TMT (technology, media and telecommunications) bubble, multiple corporate scandals (Enron, WorldCom, etc.), 9/11 and a weakening economy. In response, the U.S. Federal Reserve Board (the Fed) lowers its federal funds rate to provide stimulus
- In response to stimulus, the U.S. economy enters a five-year pattern of above-average growth
- Coupled with low interest rates, strong job growth and positive sentiment, the housing market surges
- To take advantage of the housing boom, mortgage originators grow their subprime lending practices

- Home owners re-finance their mortgages at lower rates to effectively increase their disposable income
- As home prices soar, homeowners finance a widespread spending spree through their home equity
- Real estate speculators use risky leverage tactics to buy multiple dwellings, often at subprime rates, with the intention to flip them and make a quick profit
- The large subprime debt pool offers an attractive yield to investors in a low interest rate environment
- At the same time, investment banks elevate their ability to securitize assets to an unprecedented level, often using complex arrangements
- Structured products such as Asset Backed Commercial Paper (ABCP), Collateralized Debt Obligations (CDOs), and the like become a popular investment due to their attractive yield premium
- Due to their complex structures, these securities lack transparency – it is difficult, if not impossible, to know what backs these securities
- Investor mania and lack of transparency results in the inappropriate pricing of risk
- Due to greed and an overly optimistic view, no one bothers to ask how they were getting a yield that in many cases was twice the benchmark 10-yr U.S. treasury for the same risk
- A basic investing tenet that higher reward comes with higher risk is ignored

2006: Cracks appear

- After peaking in July, U.S. housing market weakens significantly
- Weaker borrowers falter as they are unable to make payments on their debt
- Lenders take losses as real estate prices crater
- First sign of subprime contagion rears its head when BNP Paribas temporarily closes a fund, Bear Stearns defaults two hedge funds and HSBC writes off losses in its subprime business
- Stock markets record temporary setbacks in March and July

2007: Fear takes hold

- Stress to credit markets become too large to ignore
- Lenders, who are taking on significant losses, tighten lending, which begins the process of siphoning liquidity out of the capital markets
- Rash of subprime lenders in the U.S. go bankrupt and most of the other lenders shut down or sell their subprime business
- Financial institutions become concerned, not only about other institutions' exposure to subprime-backed securities, but their own as well since complex structure makes it impossible to adequately price the assets
- Many ABCP assets are frozen as there are no buyers and therefore the price should be zero
- The LIBOR (London interbank offered rate) rate – the rate at which banks lend to each other – climbs high enough to effectively freeze the flow of capital

- Many central banks inject capital to grease the wheels of the economy
- U.S. economy slows as the consumer turns off the spending taps
- Fear dominates the stock market, starting in late summer, sending financial and consumer-related stocks downward; resource stocks still climb on the misguided view that these stocks will remain untouched by the current problems
- Those who relied on “wholesale” financing (buying assets from a third party) are unable to secure any more capital
- LIBOR rate climbs again (almost tripling to over 6% temporarily), limiting the free flow of capital
- There are no buyers for the “tainted” assets and so deleveraging is impossible, resulting in buyouts (Merrill Lynch), rescues (AIG, Fannie Mae, Freddie Mac), bankruptcy (Lehman Brothers) and conversions (Goldman Sachs)

2008: All-out crisis mode

- Stock market volatility surges as investors attempt to make sense out of looming credit problems
- View that the emerging markets will continue to fuel commodity price growth is misplaced as oil and other commodities eventually tumble back to earth from peaks in June
- Financial institutions’ balance sheets are weakened as their holdings in subprime-related securities plummet
- Financial engineering on these securities includes significant leveraging, which results in severe devaluing
- Current value of these assets is a fraction of the par value, resulting in significant shortages in capital requirements for financial institutions to run their business
- To clean up balance sheets, financial institutions attempt to “deleverage” out of these securities
- Financials with significant deposit-taking ability are self-capitalized so they remain the stronger of the group
- Investors in money market funds panic as losses on short-term commercial paper are announced by large money market funds, resulting in a run on funds and the “breaking of the buck” (the unit value of money market funds falls below \$1 in the U.S.)

Today: On the precipice

- The value of the “tainted” assets is estimated at \$1.5 trillion; there are no buyers except for the U.S. Treasury
- The government bailout essentially means that cash or government bonds will be swapped for the tainted assets, which will be held in an account and disposed of at a later date
- The financing for this bailout will come from raising additional debt (not from printing money). This will not necessarily contribute to inflation, but could mean higher interest rates as the debt level of the U.S. government rises

The outcome

- The overnight permanent alteration of the global financial landscape, specifically the disappearance of large-scale independent investment banks, who have led the charge in investment innovation and securitization, feeds the seemingly insatiable appetite of the investing public
- Long lasting social change on par with the fall of Berlin Wall and 9/11
- Out of a period of unprecedented prosperity and overconsumption will come a new era of higher capital costs, higher savings rates, appreciation for risk, appropriate pricing of risk and fiscally constrained governments
- The cost of borrowing for healthy consumers and businesses will be higher, which creates downward pressure on the economy and the potential for higher prices (inflation)
- Recessions in the developed economies are possible and periods of economic weakness are certain as the lack of credit dampens capital and consumer spending, which only adds to the already-existing weakness in housing (consumer net worth) and jobs (consumer income)
- Bursting of the commodity bubble follows the path taken by housing and equities, which lost value as investors' inflated expectations were downgraded

For investors

- Tumultuous times often help to remind investors that they are well served by relying on professional money managers who have a history of focusing on fundamentals and ignoring the prevailing mood of the moment (be it fear or greed)
- This is not an equity market for those with a short-term view; however, removing the emotion and focusing on the long term will eventually pay off
- Historically speaking, equity markets stricken by profound fear and outright panic have presented value-oriented investors with the single greatest opportunities to buy high-quality companies at ridiculously cheap valuations
- Investors who employ a long-term approach have always been insulated from risky market exposure and rewarded for their patience
- At all times, but especially in times of turmoil, investors should stick to the financial plan that has been designed to help them meet their long-term investment objectives. Investors should consult with their advisor, who can provide the advice and support they need, and who knows best whether any changes must be made to their financial plan

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invescotrimark.com.



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