

**Dean's Executive Leadership Series - Pepperdine University / DELS  
2008-2009**

**Transcript of Presentation by Kathy Karlic, President of Institutional  
Sales and Marketing for GE Asset Management – Part 2**

**About DELS:** The Dean's Executive Leadership Series at the [Graziadio School of Business and Management](#) features in-depth audio or video interviews with today's top business practitioners and thought leaders. [Listen](#) or [subscribe](#) to the podcast to hear their views and insight on the current challenges and opportunities facing the business community.

#### Start ####

**Announcer:** The Graziadio School of Business and Management at Pepperdine University proudly presents the Dean's Executive Leadership Series. This podcast invites top business practitioners and thought leaders to share their view on the real world of business.

**Dean Linda Livingstone:** Thank you so much for sharing that. It's very insightful. A lot of those issues have probably been discussed on our classes but extremely complicated and it's good to hear it from someone that is involved in it on a daily basis. On a personal level, I appreciate you sharing your story about your family. I have a husband who some of you met tonight who I couldn't do what I do if I didn't have a husband that's very supportive and does a lot of things that are helpful. So, I understand that as well and appreciate it. Let me ask you one question before we go to the audience. You talked about the programs that are being rolled out. How much confidence do you have that it will accomplish what they want it to? What kind of lag will there be in it doing what we hope that it does?

**Kathryn Karlic:** It's hard to say when the actual cash will hit the streets and cash to buy the assets. And that's just one part of it. I think the program on commercial paper will hit more quickly. But the Treasury- there's a great website. You can track everything the Treasury is doing. Just go to Treasury.gov. Everything is right there in front of you. You can track this, which I do now. If my Blackberry were here I would probably be getting three emails about what they're doing. They have already sent out their request to find asset managers for these pools of capital. They've also sent out and have selected somebody that's the custodian, the backup people that are going to do all the record keeping. And

- 1 -

# PEPPERDINE UNIVERSITY

## Graziadio School of Business and Management

they've hired a couple of consultants as well. And so they have done all this in the span of a week. Now, I don't know where the government moves that fast but I think it takes them a lot longer to figure out what bill they might want to put on the table to talk about versus hiring people, getting the RFPs out and they are looking through all the asset management pieces. I suspect it will take at least four to eight weeks to get some rhythm about the policies, the investment practices and how will they identify which assets to go and buy. I think once the program has a few other details around it and they're buying these poorly priced and bad assets that people will say, "Oh, we're moving some of this capital back into the economy." My concern is that this is as patient capital. But we're going into a rhythm now for weaker economics. So, while we're going to more from a financial crisis, we're now starting to enter it or are in a recession or a depression that we're going to get through probably the next 12 months without feeling good about the stuff. Goldman Sachs just came out and said 8% unemployment through the end of 2009. It was just 6% a little while ago. So, we're going to have kind of this double angst. I do think that injecting the capital into the economy is absolutely necessary. I mean if anybody is an entrepreneur, what do you look for? Smart people and capital, right? And you might not do it in that order. You might say I got to get the capital so I get the smart people. But capital is what drives this. So, that program along with two or three of the others, I think will start turning around some of this just chaos that we have.

**Dean Linda Livingstone:** How long do you think you are going to keep your 401K in cash?

**Kathryn Karlic:** <Laughs> Well, let's see-- I'll give you a few thoughts on that actually. The U.S. Equity Market-- There's a home bias. You buy what you know the best so I just displayed my bias, right, fixed income. But United States investors tend to buy U.S. equities and I'm finding in my book of business, Europeans are buying European equities because they know those companies the best. But the U.S. companies, there is vibrancy. And Clarissa was on or called the other day when we talked about the evaluations of our U.S. companies are coming back down to very reasonable PE levels. So, you know you think that all these strong companies I mean, I can name a few. I can't name them in my GE capacity but you just read the papers. U.S. Steel has come down in half. IBM has come down in half. Procter and Gamble. Everything got battered because we don't know what to do with anything so we throw everything at- it's all tra-- It's all right, just do this to everything. So, again, my bias would be I would buy U.S. before I think about something broader just because you got to go back into this marketplace now. I would buy these troubled assets if I could find a way to do it. But I think that's going to be for the institutional accounts.

**Dean Linda Livingstone:** What questions do you have?

# PEPPERDINE UNIVERSITY

## Graziadio School of Business and Management

**F:** Has the Market bottomed out or do you think it will bounce around a bit. What are your thoughts?

**Kathryn Karlic:** I think in all a lot of people are asking is this the bottom? Is it not? Volatility is just going to be very, very, very high. Because we have a little piece of transparency into this marketplace but the Stock Market <inaudible> economy up before the economy recovers. I don't think that this is a time period where it's just going to start going back up once again. I think the risk tolerance is what a lot of companies are going to go back and think about. How risky was I last Tuesday? How risky am I going to be next February? That will dictate how much to your question Linda, when are people going to feel about risk and put their money back into the marketplace? And so, the other piece that I'm watching is there's lots of money in hedge funds. You can only get your money out of hedge funds at certain times of the year. So, for the redemptions for December, you had to put your paperwork in, in September. And so I don't know how many people have companies that asked to be redeemed but if they've got to sell more shares of equity to meet those yearend calls, the market's going to come down unless we have new demand for U.S. equities. And I don't think it's going to necessarily balance out.

**Dean Linda Livingstone:** We have a question right here.

**M:** How do you convince an investor like yourself, to put your cash back into the market? I know a lot of people who pulled out a year ago who have their money sitting in cash. What will it take to convince them?

**Kathryn Karlic:** I am going to go back to asset allocations. I think a lot of defined benefit programs, they actually have stated target rates for their different asset classes. So, a lot of companies do want to buy international. That's the North Star; the asset allocations. SO, if they believe this is a time when so many things have been beaten down, they won't necessarily do it. Can I convince somebody right now, this moment? I don't think so. It has to come from the heart of the Chief Investment Officer that they're ready to take their dollars and put it into another asset class. I could show you all sort of charts that go back to about 1930. It's an extremely interesting chart. If you take returns and put them across the bottom; zero, zero to 5%, 5% to 10%, 10% to 20% and then do it on the negative side. Every time period you have a negative 10% or 20%, just put that year in that column. The following two years earn that other higher 15%, 20%. So, if you believe in turned analysis like that, I can show that chart. That might convince them. And I think that's a very powerful chart because you have to be in the market to get that rebound. You can't sit in cash. I'm sitting in cash and I'm going I'll go and put some more into the equity market. I think individuals that are at the boards right now are faced with unprecedented times. And when you sit in this seat, you really want to look smart. And you may not be rewarded all the time to be the first person

# PEPPERDINE UNIVERSITY

## Graziadio School of Business and Management

in. I think we're going to see who is going to establish some leadership. I think there's going to be some private solutions to this mortgage debacle because a lot of money is sitting with private equity firms. So that might be one of the ways that there's going to be more capital injected into the marketplace by the private equity firms that would just put SWAT teams around analyzing these programs.

**Ed:** Credit risk has been in the headlines quite a bit and credit derivatives. Can you talk about the condition the market is in? Or what condition the market was in and how it has changed? What kind of turmoil the credit derivative markets are going through right now?

**Kathryn Karlic:** Let's level people on what credit default swaps are as well. So, let's go back to when I grew up, all we dealt with was cash bonds. You put your money. You give it cash, you had a bond. People wanted to figure out how they could trade in bonds and actually not have a bond or swap cash. So I could walk up to another firm and say do you know what? What do you think about-- Just pick a firm out there. What do you think about Sears? I might say I don't like it. You say you like it. I say let's do a contract and let's see where the spreads go. I'll pay a little premium or you pay me a little premium. No bond had to be there. In this credit turmoil, you price a bond over the Treasury curve. So a five year Treasury pays us about 3.5% interest. If you're a top, top, top, top, top company, you might pay 25 basis points or a quarter of 1% over that Treasury so that you could raise capital. Those firms right now, instead of 25 basis points, because we don't know how to price risk. WE don't even know- think about the AIG, which is a top quality company. Maybe you have to pay 125 basis points. You have to pay 250 basis points. And then you had all these contracts; that were just what we call synthetics. They were just contracts. They were just a promise that you and I made to each other and there was no way to account for how many of those contracts are in the marketplace. And people put just trillions and trillions and trillions of dollars of value around them but there's no way you can count them up. So, I don't know if I had a contract with you and we made a contract and you made a contract and you made these contracts. You don't know how many people were really trading around that same credit. I think the credit spreads for high yields right now are about 12% above a Treasury. They were paying 20% for a high yield bond and it's implying a lot of default risk in there. That's I think is a fair game to play right now because there will be defaults in those high yield names. If they don't get access to capital being able to refinance the risk, they have to default. There's no other place to go with that debt that's due. And private equity firms typically would buy companies that are in trouble and try to recapitalize it or they might have a rollup strategy to merge a lot of companies in the same industry together. But the private equity firms aren't interested in this ballgame either. A part of that is because when we sit in a private equity fund, there's not a lot of cash flow coming out that could be back and reinvested. So, you've had some mis-faults or missteps. People buying some securities too early so they're a little singed. And people don't want to do that. Again, they don't want to look bad. They want to look smart. A lot of spreads came down the last

# PEPPERDINE UNIVERSITY

## Graziadio School of Business and Management

couple of days and I was reading just what the recapitalization of the banks by the Treasury that the credit spreads on very major banks really snugged in by over a point and a half. So, that's very positive.

**F2:** Thinking outside the box, what do you think of the idea of the government giving \$10,000.00 to each and every taxpayer if you consider that there's about 900,000 taxpayers in the U.S. We're talking close to a trillion. The 700 billion that they set aside may not be enough for Wall Street. They may have to do a second tier. What do you think about putting cash back into the American taxpayer's pocket?

**Kathryn Karlic:** Well, I think you're going to get that with the price of oil coming down to \$80.00 a barrel. So, it's really happening naturally right now when you're seeing oil going from \$140.00 per barrel down to \$80.00. I think the market is giving that back to us, which is great because we all were used to filling up our gas tanks for \$70.00 and \$80.00 so now that should be down and half. So, that's not a tax break but it's redeploying capital from the gas tank to buying what you might want to buy. Everybody likes to buy goods. We're a nation of- we got tons of stuff, probably way too much stuff. The economic stimulus package that was done several months ago, the reports are that people say that buy down debt, buy some stuff. They got stuck with the higher gas bill is what a lot of people had said. So, if you think that it's going to have a long term impact? That's great. But I'm not sure if the long term impact is-- Let me rephrase that. I think the long term impact is to create the capital to get economic value versus us buying more goods right now, has a longer term sustainable economic impact than perhaps depending upon us who get some money and what are we going to buy?

M2: <Inaudible> how did the rating agencies report so much?

**Kathryn Karlic:** I can't be an expert on the rating agencies but I can tell you where I think some of it went wrong. There were so many people packaging up the mortgages that it overwhelmed their knowledge base. Each mortgage has a cash flow stream and there's no technology that permitted them to really stress test each of those cash flow streams so they did it in that bundled approach. They're paid by issuer so that could be a part of the problem. If I was putting together a CDL, I paid to get the rating. So, one could argue that there could be a conflict of interest in that. I think the packaging of all this debt was happening very quickly. And again, you just go how could it be an AAA? So a lot of people believed it and we stressed tested all these different charges but the rating agencies have been through a lot of chaos. Remember, we had a credit crisis before we had this structured product crisis. They were wrong on a lot of credits back then. We were talking about Kmart earlier when it went bankrupt. There have been A rated companies in the corporate world that have gone bankrupt. So, they believe they rate through a cycle, not with a cycle. I think it's very valuable when you have a team like I had at Fixed

# PEPPERDINE UNIVERSITY

## Graziadio School of Business and Management

Income for GE is that we looked at each and every security. We didn't depend on ratings. We came up with our own independent ratings. And in this big world of asset management, people are going to go back to, let's do fundamental research. We're not going to trust agencies. We're not going to trust somebody else's analysis. So they have to rebuild their reputation.

**Santiago:** You mentioned reputation during your speech. Do you think America's reputation is ruined? How will that affect the country in the long run?

**Kathryn Karlic:** No I don't. In fact, I remember the day that some of these programs were announced and I had my sales person in Harris on the phone. And he goes, "This is what I'm worried about." And he gave me a couple of things and goes, "Oh, welcome to socialism." So I was like wait a second here. I'm not sure I agree with that one. I don't. I think they are just so interwoven right now and you can think about all the different issues we have globally and you have scares around the world. You've got oil issues south of us. I'm on the West Coast now so you've got tanks to the west of us. You can think about some of the crisis with lack of laws in the part of the world with Russia. You could think about disruption because of military issues in the Middle East. No, I don't think Americans reputations are ruined. I think this is a concerted effort to try to figure out what is a global problem. There are mortgages in other part of the world as well that aren't doing so well. The UK has a lot of mortgages that they have on their books. There are problems with debt around the world and with banks around the world too.

**Santiago:** I was thinking more in the financial institutions. Is investment going to flee from the U.S. and go somewhere else?

**Kathryn Karlic:** Capital goes to good ideas. Capital will just go to where the best ideas are. If we have no good ideas, then we shouldn't get it, right? That's the heart of entrepreneurship.

**M3:** What are your thoughts about the economy after November's elective results as well as January after the President-Elect took office?

**Kathryn Karlic:** Either person that gets elected is going to have a tough, tough job. I don't think it's an issue that's a particular party issue. They just have to work through it. I think the big issue is the team in charge of this Treasury program or not going to stay in place or not because they're appointed. Hank Paulson who is really masterminding all this moves and he doesn't have to stay. The first time he was asked to be the Treasury Secretary, he said no. The man is 62 years old probably doesn't have to do this

# PEPPERDINE UNIVERSITY

## Graziadio School of Business and Management

and listen to all these cranky politicians. So, I think that's one of the issues. I don't think that the market is putting much weight on either of the individuals. I do believe that the tax programs will be widely watched. And what we don't know is if anybody, either McCain or Obama's hands are tied because of the bigger issues. What can they do because the issues of this financial rescue problem are pretty deep.

**M4:** You mentioned the lending practices are probably going to be a little more conservative based on future cash flows. What effects will that have in the housing market? How will that trickle into the economy? It sounds like housing will go down a lot further.

**Kathryn Karlic:** They don't have to go down a lot further. There is no reason they have to go down. I think what has to change is you go back to the basics of lending against 80% of a property value. Validating the income. Making sure that we as individuals have some responsibility for our own self finances of buying the house that we can afford not what the bank might be able to put in front of us. Auto loans are going to have issues because you've got a lot of issues with our companies. Chrysler and GM thinking they might be merging. I don't know. Can they give us 0% financing for that car that we all want? They set the programs up so they kind of can figure out the affordability limit; \$99.00 or \$199.99 or \$219.00. That's to make it affordability. They'll just stretch out the terms. I think all of that excess is just being flushed out of this system right now. I don't know how many stuffers you've had in your mailbox lately but I think a lot of those stuffers for our credit cards-- They are not one a day anymore. I Have more space in my mailbox recently because they don't know. They aren't doing the arbitrage game of great ratings and getting the fees and the 18% interest rates on the credit cards. So I think the credit is going to come in a lot of different ways that maybe we're not thinking about. But credit card availability will shrink. Auto loans, they're not going to be 0% financing. Clearly, the homes, the availability; it has to creep back into the system but it's not there yet.

**F3:** As a member of the committee that advises the Treasury, I would like to learn a little bit more about what are the recommendations and the impact of those recommendations? Are they actually being heard? Having grown up in Mexico I remember the situation of the financial crisis where the government came in and tried to revitalize the financial system. It was encountered with a lot of opposition from the public. Do you think we run the risk of encountering the same situation where U.S. government will help U.S. institutions get picked up and scooped up by foreign financial organizations?

**Kathryn Karlic:** You asked me three questions in there. I'll give you the website for the Treasury Borrowing Advisory Committee. It's all on the website and all of our minutes are right there. So, you choose to see if what we said is implemented. I could tell you that I think that they listen to our voices but

# PEPPERDINE UNIVERSITY

## Graziadio School of Business and Management

every minute is a public record. What we advise is how much and where on the curve they should issue their debt. I think it was today or yesterday, they're talking about bringing back a three year note and a 30 year note and they'll do it more frequently. And we try to figure out where people are going to want to buy the bonds. There are these things called TIPS; Treasury Inflation Protected Securities. Nobody really wants that stuff. So we said, you don't need to issue so much of that. I think they're listening but you look at the website and you see if you see some of those impacts coming. On the other piece of people buying U.S. banks, I think pieces of our banks are being bought and vice versa; around the world as well. Merges and acquisitions globally are going to happen. Again, it's where the best values are and what people can do with these companies, or you can grow a company like we do which is about 50% U.S. and 50% global within our own company. There are companies that we buy up around the world. So, I'm not sure it has to happen but do you really want your banking community to be in the hands of five or six powerhouses or would you prefer to have a choice of home many banking institutions there might be around the world. I'd pick the latter versus the former.

**Ed:** What signal did you detect that caused you to transfer you assets and how sophisticated does someone have to be to be able to figure that out.

**Kathryn Karlic:** Well, I'll tell you one of my favorite stories about the last half and then I'll tell you about the first half. There's no way that I could fix my leaking skylight right now nor could I fix my plumbing that also has a leak. I have faucets in my bathroom that are just a disaster. So I hire people that are experts. Climb on my roof and fix my faucets. And I liken this that I think that that most Americans think they know how to manage their money. But yet I don't know where we've ever educated us to manage our own money. So, we're willing to hire the plumber for \$200.00 or \$300.00 dollars an hour or whatever they run out here but we want to do our own magic with our dollars. To me, there's something odd in that equation. What I was just thinking about is I like signals that tell me something's happening. I just saw that there was no catalyst for the equity market to continue to go up. I looked at oil at \$150.00. I looked at our unemployment rate. I looked at the cash flow. I looked at moving averages for the <inaudible>. These are all just signals that people have. And they're all sort of in a neutral zone. There was nothing really great, great, great, great. Maybe there was a couple of good things like cash flow of companies is really good. But there was just no real catalyst and I was getting nervous just because I knew being a fixed income expert, about CDOs. And I knew that people couldn't understand this and I knew that most people did not appreciate the fixed income market for the complexity that had been entered into our market in the last several years. So, you saw delinquency starting to happen probably back in early 2007 on home mortgages. Then they got worse. Then the severity of the defaults were greater. You kind of follow the dots and my stomach didn't want to go through a lot of turmoil I guess either.

PEPPERDINE UNIVERSITY  
Graziadio School of Business and Management

#### End ####

