Punishing Good Behavior (9-23-08)

Well, we closed a historic week in the equity markets a little behind where we started. If someone had been sleeping since last Sunday, things look pretty boring. In the middle of it, we watched the government become the largest private insurer in the world (as the owner of AIG); watched one of our largest and oldest brokers, Lehman Brothers, become the biggest bankruptcy in US history (by a factor of 6x); watched another one (Merrill Lynch) disappear into Bank of America, whose CEO Ken Lewis less than a year ago told us that he had all the fun he could handle in investment banking; gave approval for both Morgan Stanley and Goldman Sachs to become commercial banks; provided infinite guarantees on money market funds and potentially killed off the hedge fund industry. The coup of course is that we "fixed" the global financial crisis gripping the world. A busy ten days indeed.

The Fix

I was thinking that we should wait for more details before weighing in on our take but that's really not necessary. What the Treasury's plan involves is effectively the government buying the garbage off the balance sheets of the banks, which generally means mortgage securities. Since these securities continue to be marked to market, let's just assume that the average is $0.30 on the $1.00. So the bank is already carrying this position on the books at that price and at a certain rating. Considering that no large vulture investors have stepped forward (other than the one trade that Merrill did which they effectively financed) in the space, I would say that the mark to market actually reflects the true value. But if all the government does is pay market value, this does nothing to improve the balance sheet, other than injecting cash, as it doesn't free up regulatory capital. We taxpayers are going to take some huge losses because they are going to have to overpay for these things to inject any real capital into the banking system. For those of you who believe this is another version of the Resolution Trust Corp of the late 1980's, it isn't. Those assets ultimately paid off and netted a profit. Secondary CDO tranches loaded with defaulted mortgage securities in today's market isn't the same thing as owning commercial real estate back then.

Now in addition to this, out of left field come two other gems. First, we have the elimination of short selling for 800 financial stocks. How these were picked and how you change this rule is actually unfathomable. This is free market capitalism? This was required to save the system? Really? Seems to me that Morgan Stanley and Goldman Sachs (who were being clobbered on Thursday of last week) don't have business models that work, so the short sellers seem to be onto something. Everyone remember AMBAC and MBIA? The investment banks balance sheets were built with tons of debt on the back of securitization, which is now dead. They still have advisory revenue and some brokerage commissions but maybe it isn't enough to support the existing balance sheets. So that means you are effectively insolvent and potentially bankrupt. However, failure is apparently not an option, which we discuss later.

This short selling ban has an eerily familiar ring to me, as I was wearing the black hat at Drexel Burnham in the 1980's. We were blamed for the entire Savings and Loan disaster when in fact bad real estate and foreign lending were the root cause. So the club of CEO's of the largest businesses lobbied Congress to change the rules and protect them from Drexel and the crazy raiders by condoning poison pills and proxy rules that insulated them from their behavior. We seem to be watching a replay by blaming the short sellers for the fate of the financial services industry. The club still exists and will take care of each other at all costs. Is it just me or does anyone else find the timing of this "plan" interesting as the ex-Goldman head (Secretary Paulson) announces this as Goldman Sachs' stock was breaking $90?

The next announcement is potentially even bigger, yet has been receiving less publicity. Last week, one of the largest private money market funds fell below $1.00 because they owned Lehman paper and a "run on the bank" occurred. Redemptions from fear soared across a number of other large money market funds. So our solution to this was that the government issued some kind of blanket guarantee of these funds. WOW. Now why would anyone park money at banks in amounts under $100,000 when they could park millions in money market accounts at brokerage houses or mutual funds and earn higher yields? Won't that have the effect of moving monies out of banks at a time when they need the capital? Just how well thought out was this?

The Real Problems

So here is how I see things. First, securitizations got carried away and became stupid. Packaging up assets like mortgages, credit card receivables, auto loans, corporate loans, bonds and selling them to investors in various flavors (ratings) was a decent idea (with the right assets) that got carried away (with the wrong assets). We started packaging up garbage like sub-prime and the rating agencies slapped their historical models on it and AAA ratings got spit out. So the banks/investment banks sold off what they thought was the high risk stuff (lower ratings) and kept most of the "bullet proof" AAA securities. Then, these AAA securities started to default and everyone realized that they weren't really AAA. The problem was that the banks and their regulators all fell asleep. They never did the work. Don't blame just the rating agencies. The AAA assets on bank balance sheets are effectively levered to infinity with almost no capital backing them. Additionally, the investment banks get punched twice. First, their balance sheets are loaded with this type of asset and, second, they have no revenues because the golden goose of CDO creation is gone. The response to this has been that both the banks and investment banks had to raise capital in the form of selling stock and/or selling assets. Selling more stock isn't an option anymore because the sovereign wealth funds that bought in early have been destroyed, so they aren't lining up for any more. And now, nobody trusts the value of the assets or their ratings. Welcome to our world.

If this was the end of the story we could have some bank failures and then eventually move on. Unfortunately, it isn't. The elephant in the room is credit default swaps or "CDS." A CDS is like buying insurance against corporate defaults. The idea of hedging credit risk sounds pretty good. Just buy the security, lever it up and buy insurance against default. Risk free returns. Only one problem. The companies providing the insurance are the same ones who are actually insolvent—the banks and investment banks and now even the biggest insurance company in the world. So those who used Lehman to buy a CDS against a company that defaulted were smug until a couple of weeks ago. The problem here is that the numbers for CDS are in the trillions not billions. That is what the government is concerned with. The AIG interconnections gave them a view of this and it wasn't pretty.

Call the Police

So where were the regulators and where were the Boards of Directors? Aren't banking and insurance among the most heavily regulated areas? How could this happen? How was trillions of dollars of fictional insurance allowed to be created? Not only does this CDS market interweave its way through almost every major financial institution in the world but no less a guru than Alan Greenspan gave his unequivocal blessing several years ago. Yet somehow this whole CDS market remains an unregulated, private placement game? Warren Buffett argued a number of years ago that these things were "weapons of mass destruction," so how much of a surprise could this have been? Am I the only one confused when AIG comes out and says that they have $446 billion in CDS contracts in an "unregulated subsidiary"? What good is having "regulated" businesses if you are allowed to hold bombs in unregulated subs? Same program with the whole "SIV" mess with the commercial banks. If there was an effort by these financial institutions to evade the law, how is this not fraud? The Worldcom and Enron mess ended up with plenty of prison sentences but so far all we've seen in finance is large severance packages.

It seems to me that much of this gets back to something near and dear to our hearts—credit ratings. Nobody did any work. They just relied on the ratings of everyone from the counterparties who sold the insurance to the ratings of the assets they were insuring. The banks' risk departments bought off on ratings, the regulators bought off on the ratings and they told two friends and so on. Even more ironic was the role of the rating agencies in the recent failure of AIG. Their downgrades caused the capital calls that pushed AIG over the cliff. But wasn't it these same rating agencies that were responsible for the AAA ratings relied upon by AIG to build their balance sheet in the first place? One of the main reasons given for the downgrade was the falling stock price. What? So now the stock price is the key to credit risk? Someone let me off this ride.

Punishing Good Behavior

Where does that leave the average guy who pays his mortgage, lives within his means and continues to save? Or how about the financial institution that didn't play in CDS or bad mortgage CDO's (like Wells Fargo or US Bancorp)? Under the idea of free markets, aren't they supposed to benefit? Don't they take the market share and profits from those who didn't do it right? Apparently not. The spin over the past few weeks is that we have no other choice. This is an absolute crock of crap. We could go right after the heart of the biggest issue and deal with the open CDS contracts. Since default rates are still relatively low, there can be an orderly wind down or shrinking of this business. We have already demanded that these trades begin to clear on an exchange which is a step in the right direction. We could also suspend (temporarily) the mark-to-market accounting for banks and insurers until this is sorted out. There are options but it's too late for that because we, the taxpayer, are now the biggest hedge fund in the world, but with no upside. It appears that one panic reaction (run on the money market funds and the last two brokers) created another panic reaction from the government.

All Fixed?

With all of this hysteria, can we sound the all clear sign? Hardly. We saw a massive equity rally right after the announcement because of technicals. The short sellers are covering. Real estate is still down 35%, the consumer is dead, a ton of debt overhangs the system, securitization is still broken and the availability of capital and the desire of bankers to lend it is missing in action. So does this newly formed effort by the government to buy toxic assets do anything? Yes it does provide liquidity by creating a formal bid. It seems that this will be step one in the Texas two step. Once cleared of the junk, the financial institutions perhaps can raise permanent capital from the private equity firms, which do have the capital. Stay tuned, as there are bound to be many more chapters in this black comedy.

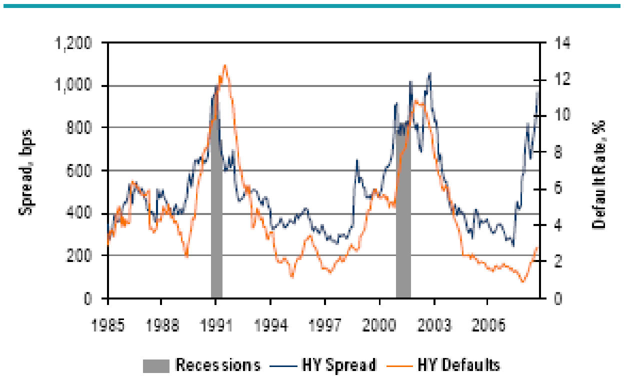
One final point. It would seem to me that we are printing monies we don't have. I'm no PhD in economics, but we are running massive trade and budget deficits and yet we are providing more than a trillion dollars to various financial institutions? How? From what account? Seems like the math behind this equation would lead to an explosion in interest rates. Then again maybe the government has a fix for that too.

The Opportunity

Before getting too acerbic and sarcastic, let's make the best out of this situation and take advantage of the potentially massive opportunity. Just what is the opportunity? Well, I think this will become clearer as the specifics evolve but it certainly appears that we might be putting in a major bottom for the financial sector. Is it time to buy some AIG bonds? How about Washington Mutual or Morgan Stanley? At this point we aren't sure, but it is time to get busy in the space and start the real work. This is all relatively new to high yield investors because financial institutions have rarely showed up in our territory. You can rest assured that we won't be relying on any rating agency to help us.

As always, the broader opportunity in high yield and leveraged loans is being created by tremendous fear and liquidity issues. Given this environment, everyone marks down prices regardless of fundamentals. This time, things are being exacerbated by the elimination or curtailment of market makers such as Lehman Brothers and Merrill Lynch. This makes markets more dysfunctional. But it is important to remember that although high yield default rates will definitely increase given the soft economy, we believe that they are unlikely to surpass the levels seen in 2002. Back then, the "TMT" (telecom, media, technology) sector represented a substantial amount of the high yield market and many of these companies not only defaulted, but provided zero recoveries. The joke was that rather than using "EBITDA" as a measure of cash flow, we would use "EBE" which stood for "earnings before expenses." In my opinion, we are beginning to see the final leg of selling or markdowns in the high yield sector. Spreads are now right near their historic highs reached in 2002 and 1991. [1]

[1] Silverstein, David and Mary Rooney. "This Week in High Yield," Merrill Lynch, September 22, 2008, page 2.



Source: Merrill Lynch

The Downside

The great thing about the high yield bond market is that math can be used to estimate potential returns. I was intrigued with a recent Merrill Lynch piece that addressed this thinking.[2] They painted a very bleak picture in their "worst case" scenario. A 12% default rate (among the highest in history), spreads blowing out another 250 basis points (worst in history), recovery values of 30% (lower than the historical average) and the calculated outcome was a loss of 2.3%.

Worst-case scenario:	
Default rate	12.00%
Defaulted par value, US$bn	$89
Market value loss to default, US$bn	$29
% change due to default loss	-4.70%
Assumed spread change, bps	250
% change due to spread change	-7.40%
% change cumulative (defaults + spread)	-12.10%
Current coupon yield	9.80%
Net effect	**-2.30%**

Now this is certainly not what we would expect to deliver, but it puts some things into perspective on timing and risk. Additionally, what this does not show is some of the natural upside potential built into this type of portfolio. In any environment, bonds will be called (call premiums) and some of the issuers will get acquired (poison puts). To us, losing money is the ultimate measure of risk. So under what we believe to be a very unlikely scenario, the estimated potential loss is manageable. Isn't that the definition of investing?

Timothy J. Gramatovich CFA
Chief Investment Officer
Peritus I Asset Management LLC

[2] Silverstein, David and Mary Rooney. "This Week in High Yield," Merrill Lynch, September 22, 2008, page 2.