CUBICASSET MANAGEMENT, LLC

2008 2nd Quarter Stock Market Commentary

ADVENTURES IN KITING

"A business conference is a meeting in which everyone says that
there is no such thing as a free lunch – while eating one."
- Anonymous

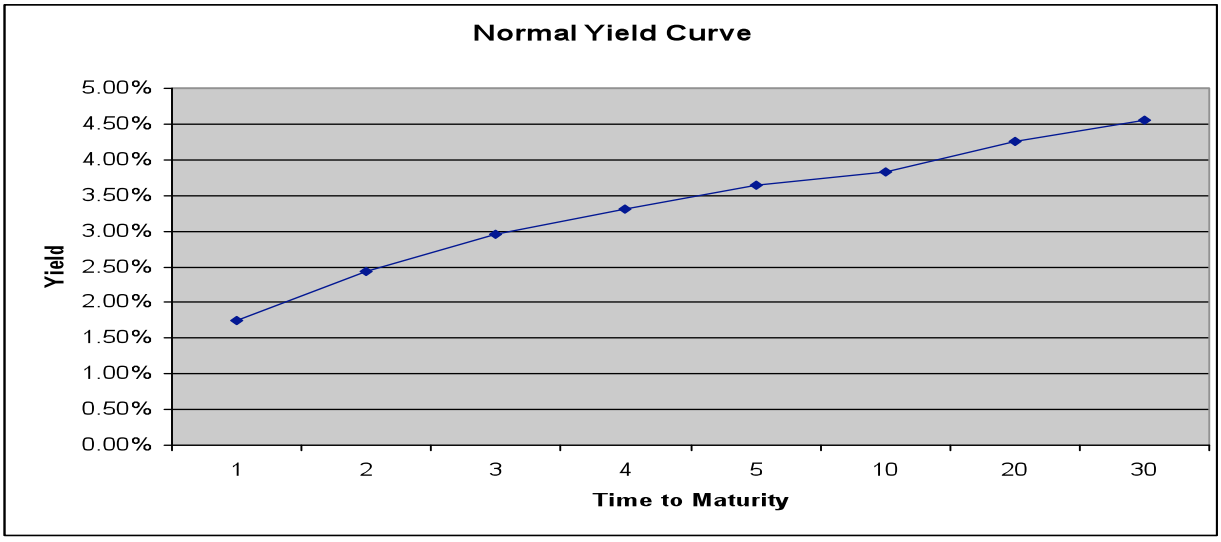
Is there anything more alluring than getting something for free? Citizens who impatiently try to cut ahead of a line of traffic at a highway exit ramp, or use the "12 Items or Less" checkout line at the supermarket to pay for a full cart of groceries, will paradoxically stand 30 minutes in the hot sun to get a free sample of a yoghurt smoothie, even if they hate yoghurt. Dan Ariely, professor of economics at the MIT Sloan School, recently authored a fascinating new book titled Predictably Irrational: The Hidden Forces That Shape Our Decisions. In a chapter about our obsession with all things free, he describes an interesting experiment that he and a colleague performed in the MIT cafeteria. They set up a table on which they offered Lindt chocolate truffles for 15 cents apiece, or Hershey kisses for a penny. Buyers could choose one or the other, but not both. Seventy-three per cent of the MIT students opted for the truffles, correctly perceiving it to be a better relative bargain. The next day the experiment was repeated, although this time the truffles were priced at 14 cents, while the Hershey kisses were free. This time sixty-nine per cent of the students chose the free kisses. So much for rational decision making!

The concept of a "free lunch" dates back to the mid 19th century, when it was common for taverns to offer their paying customers free food, generally a cold buffet, with their drinks. Since eating the "free food" first required the purchase of a drink, it was not really "free" at all.

Looking for a free lunch may seem like a harmless piece of self-deception, but it can result in dire consequences. In fact, it seems to me that the entire current credit crisis in the U.S. is the result of corporate America and the consumer all seeking something for nothing. Let's consider a few examples.

Amongst the instruments at the heart of the current credit crunch are so-called auction-rate securities. These are long-term bonds whose interest rates are reset, usually either weekly or monthly, in an auction. The typical issuer is a municipality or other tax-exempt issuer, a closed-end fund, or a student loan company. For example, suppose that the Port Authority of New York and New Jersey needs to raise $300 million to help fund its operations over the next twenty years. One possibility is to issue a twenty year bond. The Port Authority might have to pay an interest rate of 4.50% to sell those bonds. Alternatively, the agency might issue a one-month note, for which it might only need to pay an interest rate of 1.50%. The difference is due to the fact that investors typically demand a much higher interest rate to commit their money for a longer time to compensate for the fact that inflation will erode the purchasing power of

the income over the years. In the graph below, we show a graph of a typical yield curve, which shows generally rising interest rates for longer dated securities. Obviously, the Port Authority would rather pay the lower rate. But if it issues a one month note, it will be forced to issue another one a month later, and then a month after that, each time the security matures. This poses financial risk to the issuer, since at some point in the next twenty years interest rates may soar, forcing them to pay a higher rate than it can afford.



An auction rate security attempts to give the issuer the best of both worlds. Here's how it works. The Port Authority issues $300 million of long-term bonds at an interest rate that will be fixed for 30 days. Since tax exempt money market funds currently yield only 1.75%, Port Authority might have to pay a slightly higher 2% to attract enough buyers. One month later, there will be another auction. Some existing bond holders may choose not to participate in the new auction, either because interest rates are too low, or because they have other uses for those funds. The Port Authority might have to pay a slightly higher 2.2% to attract enough buyers at the subsequent auction. From the issuer's point of view, they have gotten a free lunch - long term financing at lower, short-term rates. Wall Street banks sold these as safe alternatives to cash. From the buyer's point of view, he/she has also gotten something for nothing –a higher interest rate than on traditional cash equivalents like money market funds, with monthly liquidity.

Unfortunately, neither auction rate securities issuers, nor their buyers, considered what the consequences might be if they held an auction and no one came. Currently, there are roughly 1,000 failed auctions per week. The issuers are being forced to pay interest at the higher "failed rate". In the case of the Port Authority, the failed rate soared to 20%! Trading in these securities is frozen, and buyers who had parked funds that they needed to pay current bills have lost access to their money. Hundreds of lawsuits have been filed against investment banks, claiming that they had fraudulently misrepresented these securities.

The online investment dictionary Investopedia defines "kiting" as the act of misrepresenting the value of a financial instrument for the purpose of extending credit obligations or increasing financial leverage. In a sense, Wall Street was guilty of kiting, here. And just as in the sport of kiting (i.e., flying a kite), it turns out there are always strings attached.

There is no better illustration of the desire to have one's cake and eat it, too, than the behavior of all participants in the subprime and alt-A mortgage markets. Traditionally, banks were reluctant (and rightfully so) to lend money to individuals with a questionable ability to repay, since any lost principal

would be their own. But in the 1990s investment bankers developed techniques for the packaging of a wide variety of debt into securities that could be sold to mutual funds and hedge funds, effectively removing default risk from the banks' balance sheets. This was banker heaven. They had a dramatic expansion of the number of customers served, without the potential for having to take a charge for defaults (or at least, so they thought). And since there was no perceived risk, why bother to verify the income or employment of borrowers. Of course, borrowers were also looking for something for nothing. They could buy houses they couldn't afford, with little or no money down. And if, eventually, the mortgage payment was reset to a number that was too much to pay, they could simply sell the house for a profit, repay the loan and pocket the difference. After all, the idea that house prices could only rise was as immutable a law as the law of gravity. The buyers of the collateralized mortgage obligations were also looking for a free lunch. In a low interest rate environment they were able to earn higher return with securities having the same AAA credit rating as U.S. Treasuries.

The subprime mortgage problem has been so widely written about that it is not worth elaborating. But there is another example of the search for something for nothing that is considerably less well known but which played a starring role in the development of the current credit squeeze. In 1981 the United States and the United Kingdom each instituted higher minimum capital requirements for banks. These changes were designed to strengthen their respective financial institutions. But as the volume of world trade started to soar in the 1980s, stronger financial institutions became worried about counterparty risk in transactions in which one party was more loosely regulated. Additionally, it was felt that some countries had an unfair competitive advantage because of more liberal capital requirements. To address these issues, the G-10 countries met in Basel, Switzerland in 1988 to hammer out an agreement (now known as the Basel I Accord) to standardize requirements to help stabilize the world's financial system, while adjusting capital requirements for the differences in the risk assumed by different organizations. In addition to the countries in the G-10, these standards were subsequently adopted by over 100 countries.

Over the next decade it was observed that Basel I had the general effect of reducing the amount of credit available, as banks increased capital and reduced lending to bolster reserves. Fearful that this was restraining worldwide economic growth, the same participants met again in Basel in 2001 to revise the original standards, adopting Basel II. One set of provisions of the new Accord permitted banks to grow faster if they established limited purpose investment companies known as Structured Investment Vehicles, or SIVs. SIVs funded their investments by issuing commercial paper (CP) and medium term-notes (MTN). (Following the lead of government, banks seem to have adopted the position that by using as many abbreviations as possible their actions will appear both more important and more scientific.) The funds raised were then invested in a variety of long-term debt instruments representing pools of mortgages, credit card debt or auto loans. Whenever the yield curve was positively sloped, the interest cost to the SIV for the notes it issued was less than the interest earned on the structured notes it bought, creating a steady stream of income for the bank. Moreover, because SIVs were classified as "bankruptcy remote" companies, provided they met certain tests they qualified for the "clean break" requirements between a bank and securitized assets. This meant that the assets could be removed from the balance sheet of the originating bank and thus from the risk-based capital provisions. This was bankers' heaven - all the earnings of a portfolio of securities with no balance sheet risk.

Or so it was thought. First, the yield curve inverted, meaning that short rates moved above long ones. This meant the interest cost to SIVs was in many cases higher than the interest earnings. Next, default rates on some of the securities residing in these conduits started to rise sharply, placing "bankruptcy remote" entities in imminent risk of bankruptcy. Banks had to rush to bail out their SIVs to preserve their access to credit markets. In many cases, they have brought the assets and liabilities onto their balance sheets, precisely the action they had set them up to avoid. The free lunch, once again, turned out not to be free at all.

The foundation for each of the examples discussed was the Federal Reserve's aggressive lowering of interest rates in response to the bursting of the tech bubble. It was low interest rates that drove investors to seek out the slightly higher yields of auction-rate securities relative to money market funds. It was low interest rates that fueled the housing bubble. And it was low interest rates that made the "carry trade" employed by SIVs possible, in which short-term debt was used to buy a variety of long-term assets. And now that the hidden costs of seeking something for nothing have been revealed, the Fed is aggressively trying to solve the problems it spawned by (drum roll here) aggressively lowering interest rates! Traditionally, low interest rates have fueled higher inflation. But the Fed has indicated that it thinks that a weak (but not too weak) economy will be exactly enough to tamp down price increases. This is despite the fact that the overall CPI is up over 4% for the trailing twelve months, and import prices are up 15.4%. Just like homeowners and investors, the Federal Reserve thinks it has found a free lunch. The next Federal Reserve Open Market Committee meeting is later this summer. If they want a free lunch, I'll have some baloney sandwiches sent over.