CUBICASSET MANAGEMENT, LLC

2009 2nd Quarter Stock Market Commentary

MORTON'S FORK

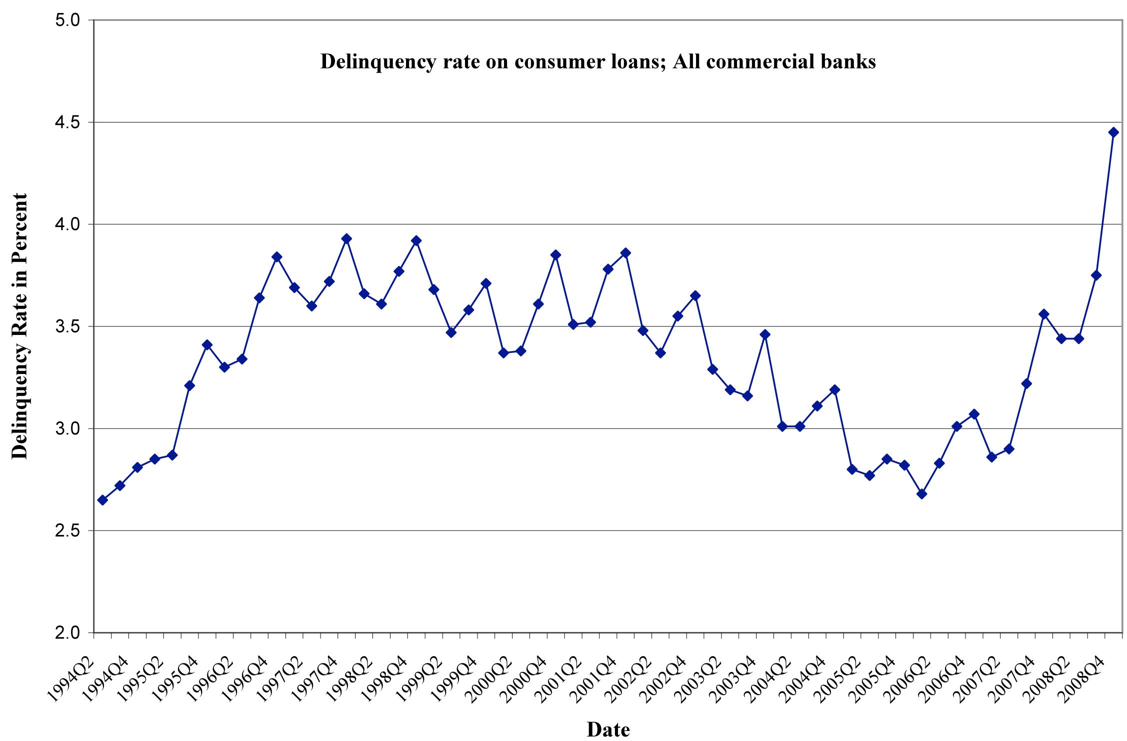
"There is a great company called I Can't Believe It's Not Butter. At least they have the decency to tell you it's not butter. They called it credit default swaps because if they called it "I can't believe it's not insurance' maybe nobody would buy it."
- Representative Gary Ackerman (New York)

In the witch trials of the late Middle Ages, women suspected of being a witch were subjected to an "ordeal by water". After being weighted down with millstones, they were tossed into a lake or river. Occasionally, the weights would become untied and the accused would float to the surface. This unlikely event was taken as confirmation that the accused was in league with the Devil, which justified them being burned at the stake after they were pulled from the water. The vast majority, though, simply sank and drowned, which was taken as proof of their innocence.

A similar situation occurred under the tax collection policies devised by John Morton, Lord Chancellor of England. Morton, the Archbishop of Canterbury, was asked by Henry VII to help rebuild the royal coffers, which had been depleted by Edward IV. In 1487 he issued the following edict to the revenue agents. "If the subject is seen to live frugally, tell him because he is clearly a money saver of great ability, he can afford to give generously to the King. If, however, the subject lives a life of great extravagance, tell him he, too, can afford to give largely, the proof of his opulence being evident in his expenditure." This type of lose-lose situation has come to be known as a "Morton's Fork". It was a Middle Ages variant of the no-good-answer question, "Do I look fat in this dress?"

Kenneth Lewis, the embattled chief executive officer of Bank of America, recently faced his own Morton's Fork. In late November, Federal Reserve Chairman Ben Bernanke and Treasury Secretary Hank Paulson approached him to broker a deal in which BofA would buy troubled Merrill Lynch. To sweeten the deal, regulators offered to inject $20 billion in new capital into the bank. Lewis announced the deal to considerable fanfare and shareholders voted to approve the merger on December 5, 2008. It was completed on January 1. Only days after, it was announced that Merrill Lynch had "discovered" an additional $16 billion in losses for the fourth quarter. Like Captain Renault in Casablanca, Lewis announced that "I am shocked, shocked…" Except that he wasn't. The losses had been discovered as part of BofA's due diligence process, but he has testified under oath that he was ordered by Bernanke and Paulson to withhold that information, lest shareholders vote the deal down and let Merrill collapse. This is despite the fact that Federal law <u>requires</u> that the CEO promptly disclose any materially significant information. Thus, it would appear that Federal officials ordered Lewis to violate the law. So why didn't he simply refuse? Lewis has further testified that he was told that his refusal to suppress the information would result in his firing and the removal of the entire Board of Directors. Talk about being caught between a rock and a hard place. Only Federal regulators could manage to concoct a situation that would engender sympathy for a major bank CEO.

Unfortunately, the above dilemma is far from unique. The government seems intent on creating a no-win situation for every banker who has accepted TARP (Troubled Asset Relief Program) money. According to an analysis of Treasury Department data by the Wall Street Journal, the 21 largest participants in TARP made or refinanced 23% less in new loans in February than they did in October, which was the month that the Treasury initiated the program. In mid-February the House Financial Services Committee held hearings in which the leaders of the major banks were excoriated for not using the funds they received to increase lending to middle-class consumers. At the same time, the Treasury subjected these same banks to a "stress-test", designed to determine the ability of these institutions to withstand a worst-case economic downturn. When the results were eventually made public, it was announced that 10 of the 19 banks tested failed, and had been asked by regulators to raise additional capital. The fact that balance sheet strengthening is incompatible with increased lending to the financially shaky consumer sector has been conveniently swept under the rug. In the graph below, we have shown the delinquency rate on consumer loans at commercial banks. Given the steep climb in the rate of defaults in the past ten quarters, bankers with strained balance sheets are not surprisingly wary of extending new loans.



In Homer's *The Odyssey,* Odysseus had to sail the Straits of Messina near Sicily. In Greek mythology, the Straits were guarded on one side by Scylla, a six headed creature that ate sailors, and Charybdis, a monster with a huge gaping mouth that swallowed an enormous quantity of water three times a day and then spit it out, creating treacherous whirlpools. The narrowness of the Straits forced Odysseus to choose which monster to approach. He chose Scylla, sacrificing several sailors, rather than risk losing his entire ship in the turbulence near Charybdis. The CEOs at the helm of the largest banks similarly have to choose having their head bitten off by a populist politician, or extend ever more credit and risk losing their entire ship.

The recent Chrysler bankruptcy offers a further example of individuals asked to choose between the devil and the deep blue sea. Prior to the filing, the Administration was intent on protecting the jobs of the UAW (United Auto Workers), a staunch Democratic supporter. Officials proposed a deal in which senior lenders would release their $27 billion in contractual claims over Chrysler's assets and accept roughly 30% of the amount owed them, leaving more assets to allocate to other stakeholders, like the UAW and the government. Twenty of the forty-six lenders balked, forcing the company into bankruptcy. Elected officials were furious. President Obama said "I don't stand with those who held out" for a better deal. He went on to call these individuals "a small group of speculators whose decisions endanger Chrysler's future." Representative John Dingell of Detroit was even harsher, calling the bondholders "vultures" and "rogue hedge funds" who "will now be dealt with accordingly in court." Populist rhetoric not withstanding, the administration may not be able to accomplish in the courts what it tried to do through bullying. Decades of court decisions have firmly established a priority scheme in which secured lenders are supposed to be paid before unsecured creditors, such as employees. And not all of the secured creditors are hedge funds, rogue or otherwise. For example, one of the bondholders who refused to give up its legal rights is the Oppenheimer Funds group. It counts teacher, police and fire department pension plans among its many investors. Under federal law, it has a fiduciary obligation to its clients. If it acquiesced to the government's strong-arm tactics, and accepted less than it thought it could obtain in bankruptcy proceedings, it would be open to class action lawsuits from its clients claiming breach of fiduciary responsibility.

Chrysler's management has its own painful choices to make, too. One of the reasons cited for the government's refusal to give additional funds to the company rather than push it into bankruptcy was its lack of fuel efficient offerings. When it was part of Daimler Chrysler, Chrysler joined forces with General Motors and BMW in the Global Hybrid Cooperation Project to develop hybrid technology, giving it access to intellectual property it can draw on. It has experimented with cylinder deactivation since 2004, a technique for increasing fuel efficiency. It attempted to develop an electric vehicle under its ENVI program. But Chrysler's financial woes forced it to sharply curtail R&D, causing it to fall further and further behind its rivals. In his automotive industry assessment report, Obama's automobile industry czar Stephen Rattner noted "On a standalone basis, Chrysler will struggle to comply with increasing fuel efficiency standards, and *it may even have to restrict the sale of certain models to make sure it is in accordance with proposed standards*." (Italics added.) Thus, in order to obtain government support to deal with its crushing debt load, Chrysler will have to market cars that it currently is incapable of producing, and curtail the sale of those few models for which there is demand.

The current worldwide financial crisis is, at its core, a huge de-leveraging of consumer and business balance sheets after a decade of bingeing on low-cost debt. The contraction has created a crisis of confidence about the future. Banks have choked off consumer credit for fear that they will not be paid back, corporate executives have curtailed capital spending and slashed dividends to re-liquify, and businesses of all sizes continue to slash payrolls to right-size for a downturn whose bottom is not yet in sight. The government's efforts to avoid systemic risk were, and remain, essential, because only the U.S. government has a balance sheet large enough to absorb all of the losses and make all of the guarantees that will stabilize the economy. But eventually, the goal is to get the government out of the business of micro-managing business and attract private capital to replace that provided by strapped and angry taxpayers. The only way that can be accomplished is through a public-private symbiosis. In the current environment, it is impossible to imagine chief executives working cooperatively. They are subjected to public verbal floggings for being at the root of all the financial woes, while government has been complicit in almost every decision that created the crisis, from the Federal Reserve's too easy money policy, to the unwavering support of Fannie Mae and Freddie Mac's reckless risk-taking, to a contradictory regulatory environment. Coercing CEOs to break the law, such as instructing Ken Lewis to suppress vital data that should be disclosed to shareholders, or excoriating portfolio managers for honoring their fiduciary obligations, are not policies designed to rebuild trust. And make no mistake: trust matters. The tattered financial services sector will not attract new capital if investors feel that their property rights will be abrogated for political purposes. The casual dismissal of legal principles is more characteristic of governments like Venezuela, Cuba or Russia, rather than the United States. These are not countries with robust capital markets. Let's hope that the current policies are just a temporary overreaction caused by anger at seeing the video "CEOs Gone Wild."