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2008 4th Quarter Stock Market Commentary

THE MOTHER OF ALL MARGIN CALLS

"Henry Paulson's plan to change his plan to whatever
the Europeans are planning is working."
- Stephen Colbert

In May, 2001, the capital city of New Delhi, India was gripped with fear by reports of a strange, four foot tall creature, with glowing red eyes, covered with heavy black fur, and wearing a metal helmet, metal claws and three buttons on its chest. Hundreds of separate people reported being attacked by Monkey Man, as he was dubbed by the local press, and receiving bites and scratches. In Time Magazine, on May 21, 2001, it was reported that a five-month pregnant woman fell down a flight of stairs in the dark fleeing from Monkey Man, and two other men leaped off their roofs to escape attack. All three died in the hospital of their injuries. A dark-complected van driver who was short of stature was set upon and beaten by an angry mob who mistook him for the mysterious creature. Some newspaper reports described Monkey Man as a monster with a black monkey face. Others said he was a Hindu Bigfoot. It was speculated that he was a cyborg that could be deactivated by throwing water on the motherboard hidden under the fur on his chest, while another report claimed he was a half-human spy in an iron mask sent from neighboring Pakistan to destabilize the capital. A month later the news service Pravda reported that Monkey Man was last seen boarding an Aeroflot flight to Moscow. These reports coincided with a series on Indian television showing the adventures of the Hindu monkey god Hanuman, showing him leaping great distances and performing incredible physical feats. Coincidence? I don't think so.

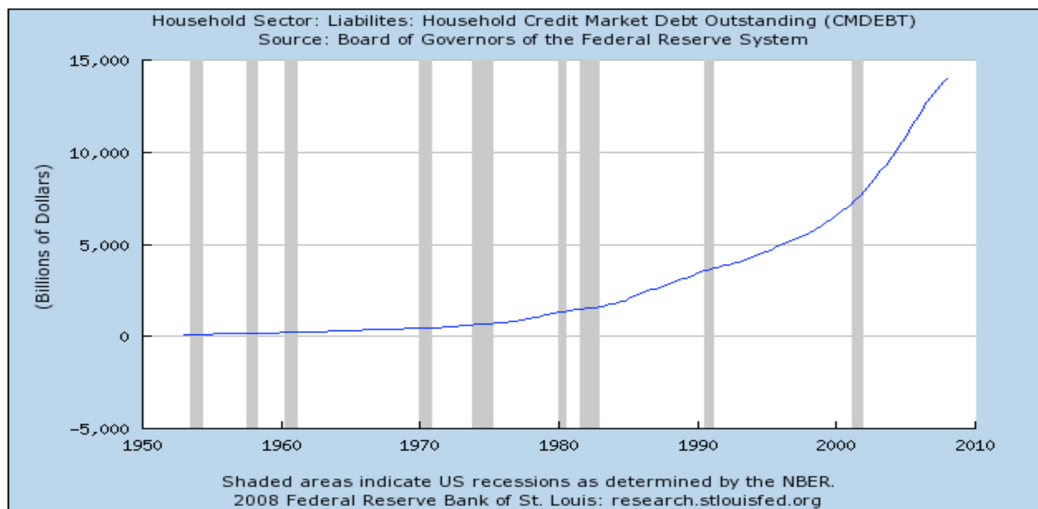
The monkey man is only one of thousands of examples of psychogenic behavior, or mass delusion. In 1518 in Strasbourg, France, a woman began dancing non-stop in the streets. She was joined by 34 others within a week and eventually there were over 400 dancers, most of who died of heart failure or heat stroke. There was an entire town in Tanzania which suffered bouts of laughter for eighteen straight months. During the Middle Ages, all of the nuns in a French convent began meowing like cats for months until police threatened to beat them unless they stopped. But none of these mass delusions, which affected only a few hundred people each, comes close to the scale of the delusion suffered by nearly the entire population of the United States and which persisted for years – namely, that it was not possible to get a nationwide decline in real estate prices. A 2004 report jointly written by the top economists at five organizations — the industry groups for real estate agents, home builders and community bankers, as well as Fannie Mae and Freddie Mac, the large government-sponsored backers of home mortgages — was typical. It said that "there is little possibility of a widespread national decline since there is no national housing market."

Top government officials were more circumspect but still doubted that the prices would decline nationally. Alan Greenspan, the former Fed chairman, said the housing market was not susceptible to bubbles, in part because every local market is different. Then Federal Reserve Chairman Alan Greenspan urged home buyers to get adjustable rate mortgages. In a 2005 speech, he praised the technologically driven marvel of sub-prime mortgage lending, which expanded the opportunity of homeownership to almost everyone.

Towards the tail end of a startling run-up in housing prices, Business Week published a survey of wealthy Americans (Business Week, December 20, 2005) prepared by PNC Financial Services Group. According to the survey, 65% of those surveyed said they expected to see double-digit increases in the value of their primary homes over the next five years, with 31% expecting an increase of 20% or more. Only 7% of wealthy Americans expected any decline in the value of their primary homes over the next five years. Broken down by region, Floridians, who had seen the greatest appreciation, were the most bullish.

Once in the grip of this delusion, all manner of strange behaviors became possible. Bankers convinced themselves that it was prudent to lend to home buyers without verifying their income or demanding a down payment, because, after all, the home (which could never decline in value) was collateral for the loan. Buyers could strain to buy houses they could not afford, since prices could only go higher. Most mortgage backed securities received AAA credit ratings, since the collateral behind the mortgages could only appreciate. And consumers went on a decade long buying spree, fueled by a seemingly inexhaustible supply of funds obtained through second and third mortgages. But one day, just as in the children's story of the emperor's new clothes, the delusion was burst by rising default rates, triggering the largest margin call ever.

For a decade, low interest rates, plus the belief that the prices of houses could only go up, fueled an explosion in borrowing. On Main Street, consumers borrowed to buy an ever larger house or condo – and sometimes two – and then borrowed again against the increasing value to buy something else, like a flat screen television, or a new boat. The graph below, prepared from data provided by the Federal Reserve Bank of St. Louis, shows the explosion of consumer debt in recent years.



On Wall Street, investment banks created securities backed by every type of consumer loan from mortgages to credit card receivables and auto loans. They had drunk enough of their own Kool Aid that they allowed their own balance sheets to swell by holding these structured notes while awaiting sale. Leverage at major Wall Street banks stretched from eight times equity in the 1970s to over thirty times

early in 2008. When delinquency rates on subprime mortgages started to rise, banks became desperate to repair the damage to their strained balance sheets by selling assets. This, in turn, damaged the balance sheets of other institutions, prompting further asset sales, creating a death spiral that wiped out Bear Stearns and Lehman Brothers, forced the sale of Merrill Lynch to Bank of America, and compelled Goldman Sachs and Morgan Stanly to convert to banks (subject to stricter regulation).

The woes of the investment banks resulted in pressure on the hedge fund industry, which relies on Wall Street for trade execution and settlement, custody, and most significantly, financing. As Wall Street firms have tightened the terms for the extension of credit, hedge funds have been forced to unwind positions, generating a sharp rise in market volatility. Moreover, the massive distressed selling has caused considerable price distortion, as managers liquidate those assets they can, rather than those (less liquid) holdings they would like to.

Prior to the recent market meltdown, hedge funds held well over $1 trillion in assets. These assets were typically levered 3 to 1, meaning that they controlled over $3 trillion in investments. By far the predominant strategy employed is a so-called Long-Short Strategy, in which a hedge fund manager owns (or goes long) a variety of companies with strong fundamentals that the manager believes will result in a stock price that will perform better than the overall stock market, while selling short a set of companies which are overpriced and/or have deteriorating fundamentals, and are thus likely to underperform. In order to meet requests for redemption, a manager must reverse these trades. That means that he/she must sell those companies with the most promising fundamentals, while buying (to cover the short) those companies with the worst prospects. The result is, to borrow from Winston Churchill, "a riddle, wrapped in a mystery, inside an enigma." The best companies exhibited the worst performance during the Great Unwind. As an example, consider that from the end of June until the trough of the market in October, JPMorgan Chase's stock performance trailed that of AMBAC by almost 100%. This is despite the fact that JPMorgan Chase has arguably the soundest financial structure of any major bank in the country, while AMBAC is a troubled guarantor of structured finance obligations whose own debt was sharply downgraded after suffering billions of dollars in losses.

This same upside-down dynamic was exhibited in almost every asset class that hedge funds focus on. Roughly 10% of all hedge fund assets are invested in commodity funds. For most of the decade, these funds leveraged themselves up by borrowing in Japan, where rates were kept near zero to combat a two decade long period of deflation. Hedge fund managers then invested those proceeds in oil, coal, copper or steel, whose prices were soaring because of increased demand from the emerging middle class in the BRIC countries - Brazil, Russia, India and China. This is one variant of what is known generically as the "carry trade," in which money is borrowed in a low cost country to be invested either in some asset showing strong, positive price momentum, or into another security paying a higher return than the interest rate on the loan. More stringent lending requirements, combined with client redemptions, have forced the reversal of these positions. The result has been a stunning collapse in commodity prices. Copper dropped more than 55% from its peak and crude oil fell over 75%. Even gold, typically a safe haven during times of financial turmoil, declined more than 15% from its peak. At the same time the yen set new highs against almost every other currency, despite the ongoing economic travails of Japan, as managers scrambled to obtain yen to repay their loans.

Another 5% of hedge funds utilize a strategy called convertible hedging. In this strategy the manager owns convertible bonds, a fixed income security that pays interest like any other bond, but which has the additional feature that the bond holder can convert it into stock at a pre-determined price. These are a traditional financing vehicle for companies whose finances are too shaky to permit them to raise capital using straight debt or equity. Against this position, the hedge fund manager will typically short common stock, creating a hedge. Generally, the value of the convertible bond and the common stock will move together, allowing the fund to earn the interest on the convertible bond without being exposed to

significant market risk. The optimal outcome is typically when some piece of bad news causes a very steep drop in the stock. This produces a big gain on the short stock position. The convertible bond usually does not drop as sharply, because it is supported by its bond value. That is, the interest paid serves as a floor under the bond. But in the current deleveraging, forced selling of convertible bonds has driven them down precipitously. In fact, the convertible bond market fell more than the stock market. At the same time, short covering boosted the price of common stock. These imperfect hedges have decimated the performance of several well-known hedge funds, such as Highbridge Capital Management and Citadel Investment Group.

So how should investors deal with an environment in which the stocks of companies with good fundamentals perform worse than those that have shakier prospects, in which some bonds turn out to be riskier than stocks, and where traditional safe havens like gold offer no protection? The temptation for some, unfortunately, has been to run to cash, a dyslexic interpretation of the admonition to buy low and sell high. Rather, this indiscriminant selling has created the opportunity for long-term investors to make terrific purchases at distressed prices. Consider the price of oil as one example. Worldwide supply and demand are reasonably balanced at roughly 85 million barrels per day. China, with its population of 1.5 billion uses only 19.5 million barrels per day, less than the 22 million barrels consumed in the United States with a population only one-fifth as large. Eventually, China's emerging middle class will increase its usage. If per capita consumption was to rise to only 50% of ours, that would create a demand for an additional 35 million barrels of oil per day, a quantity that cannot be supplied by today's technology and infrastructure. It is inevitable that the price will be much higher in the future, even if it should trade lower tomorrow.

The situation is similar for stocks. Many companies, such as Intel, Microsoft, Exxon Mobil and Eli Lilly, to name just a few, have no net debt. They generate substantial free cash, meaning that they can self-finance their operations. The credit crunch is no more than an annoyance in the implementation of their business plans. Moreover, since many of their competitors are capital constrained, such companies have a huge competitive advantage now. They can expand market share through acquisitions, or repurchase shares at accretive prices. They trade significantly below historical averages on every traditional measure of cheapness: price-to-earnings, price-to-book value, price-to-sales and price-to-cash flow.

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