The Pain of the De-Leveraging Process

For the past three years we have repeatedly raised red flags in relation to the unprecedented speculation that pushed real estate prices ever higher. Excessive liquidities were made available as a result of Mr. Greenspan's very soft monetary policies following the 9/11 attacks. Interest rates were kept too low for too long according to many, which triggered the real estate boom and bust that we now know. Cheap and easy access to cash encouraged mortgage lenders to welcome unqualified borrowers to buy their dream real estate property at discounted mortgage rates, financed at 105% and payable over 40 years. A very large proportion of those mortgages were issued below prime (subprime) with a variable rate to be fixed, in most cases 12 or 24 months down the road.

Fannie Mae and Freddie Mac (the lender to mortgage lenders) were raising cash of their own by issuing bonds "perceived" to be government-guaranteed and carrying a premium over U.S. Treasuries. Japan and China were among the largest buyers of such securities. As cash was flowing in cheaply at Fannie Mae and Freddie Mac, they were irresponsibly making it available to mortgage lenders and banks who, in turn, did the same to any potential home buyers. As their profitability was a function of volume and not the quality of the loans, poor people were suddenly realizing the "American Dream" and buying prestigious houses. Some of them bought for themselves, others for speculation.

Eventually, inevitably, reality caught up, and when the re-set rates started to kick in, foreclosures became unavoidable. As more houses came on the market, prices started to fall and soon, mortgage lenders found themselves in financial difficulty, with Fannie Mae and Freddie Mac floundering with the rest of them. Along the way, however, in an attempt to refinance and restructure failing mortgage lenders, larger investment banks collateralized some of the weaker lending institutions and issued a new form of debt instrument they called collateral debt obligations or CDOs. Financial engineers somehow were able to convince both S&P and Moody's to rate these CDOs "AAA" and they were sold all over the world. Remember: Rule #1 of investing is "diversification". So U.S. investment banks were able to share these newly created notes with the rest of the world. Today, we find this re-named "toxic paper" on most banks' balance sheets.

This is obviously a major problem that could have negative repercussions on the economy. However, if it was the only one, the Fed and the Central Banks could cut interest rates and add a few "life jackets" and things would get better. Unfortunately, we also have to deal with the excessive leverage that hedge fund money managers (those who buy and sell securities on margin) have accumulated in a similar way than their counterparts in real estate (see Example 1 and 2)

Example 1- Real Estate

	Buyer A	Buyer B
House Cost	$200,000	$200,000
Paid	Cash $200,000	Down Payment $20,000
Mortgage	$0	$180,000
Selling Price 1 yr Later	$220,000	$220,000
Rate of Return	$\frac{20{,}000}{200{,}000} = 10\%$	$\frac{20{,}000}{20{,}000} = 100\%$

Buyer B bought exactly the same house at the same price as Buyer A but "B" financed or borrowed $180,000. So B invested 10 times less cash than Buyer A and therefore has a 10 to 1 better rate of return in a positive market excluding interest and taxes. The use of leverage (borrowed funds) enhances the return in a similar multiple. However, what if the market value decreases to $180,000? Buyer A who fully paid for the house is down $20,000 on a $200,000 investment, or -10%. In comparison, Buyer B has lost 100% of his net investment of $20,000 and his $180,000 loan is subject to be called by the bank and risks foreclosure. Due to impressive performances resulting from the use of leverage, hedge funds attracted billions of investors' savings over the last few years. Given the use of borrowed funds equivalent to 2 to 3 times available capital, hedge funds pushed stock prices continuously higher.

Example 2- Hedge Funds

	Buyer A	Buyer B
Contribution	$100,000	$100,000
Leverage	$0	$200,000
Total Investment	$100,000	$300,000
Stock Market Return (10%/yr)	$10,000	$30,000
Value after 1 yr	$110,000	$330,000
Net Rate of Return	$\frac{10{,}000}{100{,}000} = 10\%$	$\frac{30{,}000}{100{,}000} = 30\%$

Here again, leverage acts like a multiplier of performance. When markets fall, margin calls are imposed and stocks have to be liquidated regardless of their underlying value. A 10% drop of the index could generate a 30% liquidation of a hedge fund to cover the margin. The increasing selling volume could push another hedge fund in liquidation, which raises even further the selling pressure. This is the vicious circle that we worried about and referred to in previous newsletters and the consequent risk of a domino effect.

Hedge fund managers needed to hedge their bets and one way to do this is to sell short the lenders (i.e. the Banks) if it is perceived they have over-extended their loans. So they were lobbying the government to relax some of the short selling rules. For the unfamiliar with the concept, "shorting" or "selling short" means to sell a stock you do not own with the expectation of buying it back at a cheaper price. In order to achieve this, you must first borrow the stock. Brokerage firms offer this flexibility for a fee. Physical delivery of the security doesn't usually take place, but it is supposed to be held in segregation. This is where some of the rules were boxed. To sell short without borrowing a stock is called "naked short selling", and hedge funds took advantage. Abusive naked short selling was instrumental in bringing down Bear Stearns and Lehman Brothers according to some critics[i].There was also another rule, established back in 1934, to ensure an orderly market. Known as the "uptick rule", it requires that every short sale transaction be entered at a price that is higher than the price of the previous trade (ensuring that the order is filled on an "uptick"). The uptick rule prevents short sellers from adding to a downward momentum at will in order to create a panic and cover at a lower price. The rule was suspended on July 6, 2007 to satisfy hedge fund lobbyists, the argument being that there was no such rule on the buy side. This, according to them, would create a more transparent marketplace: if the management of a company was doing a good job, we could drive the stocks up; in the absence of good and efficient management (measured by short-term performance), we could drive the stocks down and impose a change in management. CEOs and hedge fund managers were fighting for control.

Converging with this rippling scenario was the introduction of a new accounting rule. After the technology bubble burst, in an attempt to make corporate financial statements more transparent, new accounting rules were proposed, among them the FAS157 (Financial Accounting Standard) rule, which relates to the "fair value" of assets. The tech bubble showed us how some companies (Enron, WorldCom, etc.) were prone to flights of fancy, giving their assets "price to make believe", propelling their stock values to artificially high levels. Thus, to prevent the optimistic valuation that often characterizes an asset owner, it was believed that we ought to value asset with the skepticism of a risk-averse buyer, i.e. at the price it could be sold for at the time of reporting. This "mark to market" rule became effective on November 15, 2007. In theory, it seems a reasonable and transparent approach, but is it? The reality is that the larger the asset, or the more complex and sophisticated the asset, the fewer the buyers, and the larger the spread between the bid and the offering (i.e. the more

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[i] http://www.fool.com/investing/dividends-income/2008/09/22/the-truth-about-naked-shorts.aspx

difficult it is to evaluate!). For example, would you personally lend a second or even a third mortgage? And if you did, then wanted out of that deal, how many people would there be willing to assume the same risk? And at what price, or cost to you? So what is the value of that risk? Can it be worth $0 on your balance sheet? The point here is that the FAS157 rule is becoming a victim of its own regulation. It looks more like a regulatory trap, created as an unintended consequence of a well-meaning accounting rule. Its application in the financial industry appears to be a disaster as it implies that the value of second- and third-tier loans could have a worthless immediate value but could potentially reach full value at maturity. In an article that appeared on CFO.com written by Stephen Taub on November 7, 2007 (a week before the implementation of FAS157), the Royal Bank of Scotland Group estimated that U.S. banks and brokers could potentially face hundreds of billions in writedowns given the collapse in the subprime market and the inability to price most of these “level 3” assets (i.e. CDOs, asset-backed and mortgage-backed paper, etc.).

So, the imploding real estate bubble in 2007 combined with the lack of vigilance in short selling and margin rules and the introduction of the “mark to market” accounting rule, also in 2007, turned-out to be the 1-2-3 punch the 2008 market had to absorb. Hedge funds had no mercy for U.S. financial institutions. They sold them short and hedged their bets buying oil, gold and other commodities on margin. The strategy was, as financial stocks fell, so would the U.S. dollar, and commodities (priced in U.S. dollars) would go up. That strategy paid off, but not without creating a big dent in the financial system. U.S. bank stocks lost their ability to raise needed capital (by issuing shares) and maintain the confidence to lend to each other. Things started to turn sour for hedge funds when the U.S. dollar started to strengthen after Russian tanks rolled into Georgia. The resulting strength of the U.S. dollar pushed oil prices lower, to the point that margin calls set in. Furthermore, heavy sales of foreign assets held by U.S. hedge funds who were strapped for cash, was converted back in U.S. currency, also contributed in driving up the U.S. dollar. On Tuesday, September 2, 2008, a major U.S. hedge fund (Osprey Investment Management) was forced to liquidate all of its assets, as it became under margined. The liquidation of that fund pushed all commodities lower, as it specialized (like most hedge funds) in commodity trading. As a priority, managers would sell foreign assets and convert back in U.S. funds to meet both margin calls and accelerating redemptions. As a consequence of the massive conversions in U.S. dollars, all foreign currencies devalued against the dollar. Other hedge funds that could barely keep their heads above water quickly went under as the unwinding took place. This triggered a domino effect, again caused by the excessive use of leverage, destabilizing even further the financial sector infested with greed, and lacking basic, fundamental regulations.

At this point (October 4, 2008) new capital is on the way, thanks to Mr. Paulson’s bailout package, but it must be accompanied with a real estate rescue package and the introduction of new trading rules which should not give more powers to traders over CEOs. In conjunction, new compensation rules have to be established to limit the abuse by senior management on the back of shareholders. Hopefully, the new White House administration will introduce such new rules, but it will take time for the changes to reach our pocket book. The financial system is knocked down. It needs to regroup, revitalize, and restore proper discipline to get back on its feet.

Conclusion:

Over the last three years we have raised the fixed income component of your portfolio in view of the deteriorating environment. Although it took that long for the market to adjust, we did not expect it to be so vicious. Caught between increasing fixed income at 3% and 4% rates and insuring a proper return, investors had a tendency of maintaining a higher weighting in equities, thus exposing themselves to higher volatility. As this market continues to slide, inflation pressures seem to be fading. Commodities, being the darlings of the past few years, are targeted as the next best “short”, given that the government has restricted “short selling” of all financial stocks until October 9. But if the solution to “fix” the problem is printing trillions of dollars, that spells devaluation of currencies which could cause inflation to return a year or two from now.

Meanwhile there are only two places to hide; cash and gold, and we have both. We always have too much of what is falling and not enough of what is not. Although we might have been guilty of being too early on raising liquidities and the fixed income component in our portfolios, we have been more cautious than most over the past three years. At this point, gold stocks are not rising at the same pace as bullion. This is most probably because of the extraordinary amount of margin calls in the system, which is forcing the liquidation of enormous portfolios to cover underlying debt, creating more sellers than buyers. Eventually, gold stocks will catch up. Gold is making new highs in most currencies except in U.S. dollars at this time.

With regards to all other sectors, the focus is not only on the balance sheet and debt-to-equity ratio, but mostly on when debt is due for refinancing. Given that banks don’t even trust each other to lend to one another, lending rates to corporations have skyrocketed. Corporations borrow at LIBOR (London Interbank Offered Rate), plus a corporate premium. LIBOR is equivalent to the Central Bank’s rate plus a premium (usually very small). That premium has increased sharply and, tacked on to the corporate premium (also under upward pressure given the economic slowdown), the cost of borrowing has doubled in certain cases. This is where luck can be on your side. If all your corporate debt has been fixed and is maturing in a few years, your cash flow and costs are more predictable and sustainable than if your debt matures during this very bad spell. Current rates could be as much as twice your previous cost of financing.

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*Excerpts from the Canadian Equities Guided Portfolio, September 2008

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