The HCM Market Letter

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How To Fix It

> "This disposition to admire, and almost to worship, the rich and the powerful, and to despise, or, at least, to neglect, persons of poor and mean condition, though necessary both to establish and to maintain the distinction of ranks and the order of society, is, at the same time, the great and most universal cause of the corruption of our moral sentiments."
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> Adam Smith, The Theory of Moral Sentiments (1759)

Twelve Basis Points

One way of measuring how perilously close the U.S. financial system came to melting down in mid-March 2008 is to look at how low the rate on one-month Treasury bills fell at the depths of the crisis. That number is 12 basis points. **0.12%.** The three-month Treasury bill rate, which our friend Jim Bianco of the highly respected Bianco Research points out is the "risk-free" rate for many models such as the capital asset pricing model, the arbitrage risk pricing model and the Black-Scholes pricing model, fell to a 50-year low of 56 basis points on Tuesday, March 25. **0.56%.** As Mr. Bianco pointed out, these bills were yielding less than Japanese 3-month financial bills for the first time since July 14, 1993.

And it's not as though the Japanese economy is flourishing. In fact, quite the opposite is occurring as Japan continues to struggle with the aftermath of its lost decade (which is stretching into lost decades). Hilary Clinton, who looks increasingly unlikely to lead her party in the upcoming Presidential election, is definitely onto something when she warns that "[w]e may be drifting into a Japanese-like situation. I don't think we can work our way out of the problems we're in for the broad-based economy through monetary policy alone. Japan tried that and tried and tried that."[1] The structural problems ailing the U.S. economy are severe. They derive from bad economic policies and bad political values.

American Capitalism In Need of Repair[2]

We all know Adam Smith as the author of the bible of capitalism, The Wealth of Nations (1776). But he first wrote what is arguably a far more important book, The Theory of Moral Sentiments, from which the quote that heads this month's newsletter is drawn. America is rushing headlong into the 21st century without a proper understanding of what economic policies and financial tools are going to be required to prosper in a changing world. For more than two decades, the United States economy has favored financial speculation over production. Over the past century, our legal system had developed an increasingly outmoded concept of fiduciary duty that privileges short-term, single-firm interests over the kind of long-term, society-wide interests that could lead to prolonged prosperity. The current meltdown in the financial markets is a symptom of a serious disease that is eating away at the stability of our most important institutions. What we are witnessing might well be the end of American financial hegemony, which is the result of a burgeoning global economy. The current crisis in financial markets gives us an opportunity to evaluate how we can better prepare ourselves to deal with a borderless world.

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[1] *The Wall Street Journal*, March 27, 2003, p. A3.

[2] I want to thank Professor Mark C. Taylor of Columbia University for helping to edit this section of the newsletter. I urge all readers to pick up a copy of Professor Taylor's incredibly insightful and brilliant book, Confidence Games Money and Markets In A World Without Redemption (Chicago: The University of Chicago Press, 2004). This wonderful book is not available in paperback.

In spite of claims to the contrary, the American economy has become increasingly unstable in recent decades. This phenomenon picked up momentum in recent years as financial markets focused on trading derivative financial instruments rather than cash stocks and bonds. Paradoxically, the very financial instruments designed to manage risk increase mark volatility. As the distance separating lenders and borrowers as well managers and stockholders increased, debacles such as the Enron and WorldCom frauds earlier this decade and, more recently, the subprime mortgage and structured credit meltdown of today became more common. By effectively reducing all financial instruments and measures of financial value to "one's and zero's" – by digitalizing value – Wall Street removed crucial checks and balances on financial behavior, which ultimately remains a human activity. The growing use of quantitative trading models led to a market dominated by traders directing money into companies about which they know little or nothing. This leveling of all economic values to indistinguishable signs did untold damage to economic actors' ability to distinguish valuable assets from worthless ones.

In addition, unstoppable economic and historical trends such as globalization caused a shift of jobs and factories to geographic locations with lower labor and materials costs, resulting in a transformation of the U.S. economy from one that manufactures goods to one that traffics in intangible items. The result has been a shift from investing in activities that add to the productive capacity of the country to transactions and activities that are merely speculative in nature, i.e., that merely spawn more money but not more physical or capital assets. This shift from a tangible to an intangible economic base was accompanied by a change in the way in which businesses are financed. At the same time as the business base became increasingly intangible, so did the financial base. Equity was replaced by debt, and cash securities were replaced by derivatives. Much of the new financial architecture is now constructed outside the purview of the Federal Reserve and other regulators, allowing economic actors to avoid margin requirements and other limits on leverage that can prevent systemic threats. The new foundations of corporate finance can vaporize in the blink of a trader's eye. These trends have enormous policy consequences for the United States and our future standard of living.

The fiduciary law that governs our business culture reaches back to the 15th century and requires those who are entrusted with managing our largest corporations or pools of money to act in the best interests of their shareholders or clients. But the evolution of fiduciary law has developed into a mode of thinking that privileges short-term, single-company results over long-term, society-wide results. Consequently, fiduciaries are driven by a logic that dictates a focus on the short-term, which can be more accurately predicted than the long-term. But there is something deeper at work in this mindset. Fiduciary thought privileges form over substance, procedure over justice. Decisions that serve a single corporation's shareholders may cause significant harm to a wider array of interests. The entire concept of fiduciary duty must be rethought if capitalism is going to flourish in a borderless, digitalized world. Instead of a narrow focus on the interests of a single firm's shareholders, the fiduciaries of our large business enterprises are going to have to widen their arc of concern to a wider group of constituencies. Without such a broadening of focus, narrow interests will continue to place the entire system in jeopardy because of the networked nature of today's financial markets.

Some Specific Recommendations for Financial Reform

Nano-scopic interest rates are a sign of just how corrupted our financial system has grown from the twin diseases of leverage and greed. The collapse of Bear Stearns was an all-too predictable byproduct of a system that refuses to look itself in the mirror. The bailout of Bear was an obnoxious necessity in view of the fact that the firm was too interconnected as a Wall Street counterparty and prime broker to be permitted to fail. Its collapse would have placed many hedge funds and other financial firms at risk.[3] So instead of being able to allow the firm to enter bankruptcy as a just dessert for its failure to properly manage the risks inherent in its business, the Federal Reserve and Treasury Department had to place the interests of the financial system first. The time to ask about moral hazard is not when the system is about the implode – the appropriate time for such questions is much earlier, when the seeds of destruction that lead to the necessity to bail out players that act in ways that threaten long-term systemic stability are being sown. Such questioning, and the requisite action to avoid future problems, requires degrees of forethought and forthrightness for which the power players on Wall Street and in Washington have little tolerance. Even when we skirt complete systemic collapse – and make no mistake about it, we have come as close to such an event as anyone should dare imagine – those with a stake in the game continuing are working behind the scenes to protect their interests.

The Bush Administration, under the intellectual leadership of Treasury Secretary Henry Paulson, has proposed a broad reorganization of financial industry regulation. Unfortunately, this plan merely addresses form over substance and does little or nothing to address the underlying problems that are eating away at the system like a cancer. If reform ultimately follows the path proposed by Mr. Paulson and goes no farther to outlaw the reckless practices that place the system at risk in order to line the pockets of a privileged few, we will have sadly learned nothing from the current crisis. The system is infected by deep, inbred flaws that are rendering it increasingly unstable. Free-market capitalism as practiced on Wall Street and in The City has run amok. <u>If the current crisis, and the recurring crises of the last twenty years, tell us anything, it is that market solutions are insufficient to protect the system from the greed and fear that drive markets.</u> If the deep structural cracks in the system are not addressed and corrected, the markets may not survive the next near-death experience.

This is not a time to mince words. As the poet William Blake wrote, "Opposition is true friendship." At the risk of offending many of our readers, here are *HCM*'s thoughts on how to reform the financial system.

(1) **<u>Financial Industry Regulation:</u>** There is too little, not too much, financial industry regulation. The problem with our current regulatory regime is that too many of our current regulations serve little or no purpose (for example, the pages of meaningless disclosure in Wall Street research reports that nobody reads and are often longer than the research reports themselves) or are enforced in a capricious and arbitrary manner by unqualified regulators and overzealous prosecutors. This breeds disrespect for the law and resentment among the regulated. As a result, we have a system of laws, not values, a system that privileges form over substance, process over justice. We are never going to have a sound regulatory system until we raise the compensation levels for those who are charged with insuring that millionaires are following the rules.

[3] Make no mistake, however, that by avoiding bankruptcy, Bear Stearns' executives benefitted greatly. In a bankruptcy, their 2007 bonuses would have been subject to repayment as "preferences" under the bankruptcy laws. Some will argue that Bear Stearns stock may have been worth a great deal more than $10 per share in a bankruptcy, but after time value, aggravation and illiquidity are factored in, *HCM* would argue that the JP Morgan Chase deal was still preferable to a bankruptcy ordeal.

HCM often hears the argument that too much regulation will force business offshore and render the U.S. financial industry less competitive. Our response to that argument is that institutions and fiduciaries in the end will gravitate to the system with the strongest and wisest regulatory protections. Moreover, we should be pushing the most reckless practices out of our markets and into other markets. We should be creating global competition over best regulatory practices, not worst ones.

(2) **Wall Street Compensation**: The financial incentive system that governs Wall Street – and by "Wall Street," we mean the investment and commercial banks, private equity firms and hedge funds – requires dramatic rethinking. As compensation is meted out today on Wall Street, too much is paid to too few for doing too little of value for society. Too much capital is allowed to exit investment banks in the form of annual cash compensation. Executive compensation should be calculated based on multiple years of performance and subject to high water marks and claw backs in the event one year's profits from a transaction or a specific activity are lost in later years when that activity turns out to have been fraudulent or flawed. The subprime mortgage business is a case in point. Why should bankers be permitted to retain bonuses earned with respect to the closing of subprime mortgage CDOs that subsequently led to losses for their firms and investors? Compensation should be based on a longer-term view of value-added. Furthermore, regulators should permit firms to maintain reserve accounts and make other arrangements to facilitate a more nuanced compensation structure with adequate disclosure to keep investors fully informed.

Private equity managers and hedge fund managers should not be compensated based on returns attributable to inflation or the market. Their performance fees should be subject to a hurdle rate that is based on annual inflation rates and the applicable asset class performance (equity market performance in the case of private equity firms, for instance) to insure that investors are really paying fees for performance, not for fortuity.

(3) **Private Equity**: The private equity business has resulted in the overleveraging of American business. One result is that many businesses are short-changing capital expenditures and research and development in order to service debt. Despite the statistics promulgated by self-serving, private equity-financed industry groups, it is irrefutable that companies would have more money to contribute to the productive stock of the economy if they were devoting less money to servicing their enormous debts. We will look back at the private equity boom as a phenomenon that damaged the American economy and impaired America's competitive position in the world.

The private equity boom is the quintessential example of what the economist Hyman Minsky termed "speculative finance" and, in its most extreme form, "Ponzi finance."[4] Private equity deals add little or nothing to the productive

[4] See Hyman Minsky, Stabilizing an Unstable Economy (New Haven: Yale University Press, 1996), p. 70. ("A unit that expects its cash receipts to exceed its cash payments in each time period is engaged in what we will call hedge finance. On the other hand, an organization from which the contractual cash flow *out* over a time period exceeds its expected cash flow *in* is engaged in either speculative or Ponzi finance. A unit in a speculative or Ponzi financing posture obtains the cash to satisfy the debtors by selling some

capacity or capital base of the economy. Instead, they merely create debts that have to be serviced and divert cash to the activity of servicing debt rather than creating jobs or funding new projects or research. In 50 years, it is going to be clear that the U.S. economy has paid a terrible price for this.

Private equity managers' (and hedge fund managers') "carried interests" should be taxed at ordinary tax rates, not at the capital gains rate. Such earnings are nothing other than compensation, not earnings on risk capital.[5] The arguments that private equity firms have tried to promote on Capitol Hill that such a taxation regime would reduce risk-taking are completely unsupportable from a factual standpoint. Henry Kravis and Stephen Schwarzman are not going to stop doing deals because they have to pay taxes at the same rate as their chauffeurs. These arguments are also the most cynical kind of politicking that insults the intelligence of every American. If politicians want to be held in even lower regard than they already are, supporting these arguments is a good way to go.

Finally, private equity firms should not be permitted to go public. The discipline of the markets – i.e. 50 percent or more declines in the price of private equity firms' stocks such as The Blackstone Group (BX) and Fortress Investment Group (FIG) – is inadequate to police the abuses of such transactions. These firms are hopelessly and terminally conflicted between their fiduciary obligations to their limited partners and their fiduciary obligations to their shareholders. The fact that investors are willing to ignore the mind-boggling hypocrisy of IPOs of businesses that are built on the premise that public ownership is economically inefficient is a tribute to the insatiable greed that has consumed investors. That greed has not only corrupted investors' moral sentiments, as Adam Smith wrote more than two centuries ago, it has crippled their common sense.

(4) **Financial Institution Leverage:** Allowing investment banks to be leveraged to the tune of 30 to 1 is the equivalent of playing Russian roulette with 5 of the 6 chambers of the gun loaded. If one adds the off-balance sheet liabilities to this leverage, you might as well fill the 6th chamber with a bullet and pull the trigger. If this continues, the odds of a systemic crisis more severe than the one we are experiencing are near 100%. An absolute leverage limit should be imposed on investment banks and other financial institutions.[6] Some will argue that limiting financial institution leverage will render these businesses less profitable and less competitive with non-U.S. companies. *HCM*'s response is – "so what?" Perhaps less profitable investment banks will result in more of America's talented students becoming scientists, engineers, doctors and teachers instead of investment bankers and mortgage traders. What would be so terrible about that?

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assets, rolling over maturing debt, or new borrowing; such units are dependent upon financial market conditions in a more serious way than units whose liability structures can be characterized as hedge financing." (emphasis in original)

[5] To the extent private equity investors invest their own capital in their deals, earnings on those investments should be treated as capital gains.

[6] The obvious question is what this leverage level should be, a question that requires a great deal of study. *HCM* would suggest that over a period of years, these firms should be required to bring their leverage down below a certain level in an orderly manner that is not disruptive to markets. *HCM* has no illusions about the anti-growth effects this could have on the economy, but we also have no illusions about the dangers of allowing the current regime to continue.

Off balance sheet entities should be outlawed immediately, plain and simple. If first Enron and now the SIVs haven't taught us the necessary lessons about hidden liabilities, the system probably doesn't deserve to survive. Speaking as someone with extensive knowledge of these off-balance sheet entities, it would not be difficult to render them extinct relatively easily. It would be doing the world a favor.

Tying this issue to the compensation question in the financial industry, if investment banks want to leverage themselves 30 to 1, their executives should be required to retain 97 percent of their compensation in their firms in the form of equity capital. The way it stands now, the ratio between capital retained and cash out is much lower (perhaps 1:1) and effectively creates a "heads-I-win, tails-you-lose" culture. For institutions that play a central role as financial counterparties and lenders, this is an unacceptable risk-sharing arrangement for society to bear. These institutions need to understand that they have responsibilities to the system, not just to their own shareholders and employees. Sure, Jimmy Cayne sold stock once worth $1.2 billion for only $61 million, but he also took out hundreds of millions of dollars in cash compensation over the years. Nobody can argue that his incentives were anything but grossly asymmetric, which may explain his ability to keep his job while demonstrating a much greater understanding of the strategies of the game of bridge than of the balance sheet risks his firm was undertaking.

(5) **Hedge Fund Leverage:** Allowing unregulated entities such as hedge funds to be leveraged 10 to 1 or 15 to 1 would be laughable if it wasn't so dangerous. Prime brokers continue to be suckers for big names and big clients (and especially for big name clients). As a result, they often extend credit to parties who are not qualified to employ it prudently. *HCM* has expressed its view on more than one occasion that fixed income strategies that require excessive amounts of leverage do not make sense and have never made sense. We would refer anybody who disagrees with us to the recent collapses of Sowood Capital Management, LP, Peloton Partners LLP and Carlyle Capital Corp. Each of these firms reportedly employed high amounts of leverage (reportedly more than 15x) in their strategies. An absolute leverage limitation should be placed on hedge funds immediately. Since the prime brokers don't seem to want to impose such a limitation, the Federal Reserve should do so with its new powers. If investors can't generate decent returns without employing grotesque amounts of leverage, they should find another profession.

We recently read[7] that John Meriwether of Long Term Capital Management infamy is at risk of blowing up a hedge fund that was leveraged 14.9 to 1 as of the end of February (and is reportedly down 28 percent year-to-date). The fund in question, Mr. Meriwether's Relative Value Opportunity Fund, reportedly has earned about 7 percent per annum since inception in 1999 through February 2008 (according to *The Wall Street Journal)* despite the use of generous amounts of leverage. According to the *Journal* article, Mr. Meriwether, like many hedge funds, charges a 2 percent management fee and 20 percent performance fee for managing his fund. We really don't mean to

[7] The following is based on an article in *The Wall Street Journal*, March 27, 2008, "A Decade Later, Meriwether Must Scramble Again," p. C1.

pick on Mr. Meriwether. Everybody is entitled to a second chance. But one would hope that an individual whose firm almost cratered the entire financial system in 1998 would have learned from his mistakes. Any way you slice it, 15x leverage is imprudent. It may look prudent compared to the 100x leverage employed at Long Term Capital Management a decade ago, but that is like saying 2 degrees below zero isn't cold because it isn't 30 degrees below zero.

Of course, the real question is why hedge fund investors are still willing to risk their money in such highly leveraged strategies. *HCM* has been asking that question for years but has yet to hear a satisfactory explanation. But since the market won't impose the type of discipline that is necessary to protect the system from boom and bust cycles, it is time for the regulators to step in.

Quantitative Strategies: Quantitative investing has not only introduced an unhealthy amount of volatility into the markets, but has contributed to a larger trend in the financial markets that divorces the investment process from the concept of fundamental value. *HCM* would defy the quants to explain in any degree of detail what the companies in their portfolios do. This is another type of investing activity, like private equity, that does little or nothing to provide capital to increase the productive capacity or physical stock of the economy. In fact, quantitative investment strategies are the quintessential "hot money." Enslaved by their computer models, they trade in and out of positions at the blink of an eye. When things go wrong, they blame everybody but themselves. Being a quant means never having to say you're sorry.

At some point, society has to figure out that the way an investor earns his money is even more important than the amount of money he makes. This is why human beings were vested with moral sentiments, so they could distinguish the quality of human conduct from the quantity of its results. Until that happens, we will continue to extol the types of investment activity that contribute little to our world. *HCM* would respectfully propose that a new school of "ethical investing" be adopted that takes into account how particular kinds of investments contribute to the economy. On this basis, quantitative strategies would be eliminated from consideration.

Short Selling: Short selling is an absolutely legitimate way to invest or hedge a portfolio. The SEC made a major error when it repealed the downtick rule last year. The repeal of this rule increased downside volatility exponentially and contributed to the ability of quantitative and other computer-driven selling to push the market lower based on technical rather than fundamental investment considerations. The SEC should reinstitute the downtick rule immediately.

Financial Triage

The magnitude of the unprecedented steps that the Federal Reserve and U.S. Treasury have had to take to bail out the U.S. financial system speaks to the depth of the problems we are facing. We may have left some steps out, but by our account the following is a list of the extraordinary actions that the U.S. central bank has been required to take to address the current crisis.

- Since last summer, the Fed has cut interest rates by 300 basis points. The result? Mortgage rates have barely budged, but they are finally starting to move lower. Unfortunately, this comes too late for many homeowners who are losing their homes.

- On December 12, 2007, the Federal Reserve created the Term Auction Facility (TAF) whereby the Fed will auction term funds to depository institutions against a wide variety of collateral that can be used to secure loans at the discount window. On March 7, 2008, the Federal Reserve increased the size of the TAF to $100 billion and initiated a series of term repurchase transactions that were expected to cumulate to $100 billion. As with the TAF auction sizes, the Fed said it would increase the size of these term repo operations if necessary. No doubt these facilities will need to be increased.

- On March 11, 2008, the Federal Reserve created a $200 billion Term Securities Lending Facility (TSLF) whereby primary dealers could borrow Treasury securities for a period of up to 28 days using as collateral federal agency debt, federal agency residential mortgage backed securities (MBS) and non-agency AAA/Aaa-rated private-label residential MBS.

- On March 17, 2008, the Federal Reserve opened up the discount window to the investment banks, which are not subject to the same regulatory limitations as the commercial banks that have traditionally had access to the window.

- The Federal Reserve made a $29 billion line of credit available to JP Morgan Chase in connection with its takeover of Bear Stearns.

- The Office of Federal Housing Enterprise Oversight (OFHEO) announced on March 19 that it would reduce excess capital requirements for Fannie Mae and Freddie Mac by one-third, from 30 percent to 20 percent. This is calculated to permit these two entities to add another $200 billion of mortgages to their existing $1.4 trillion portfolios (on an equity base of less than $70 billion). The two agencies shortly thereafter announced that they were authorized to raise an additional $5-10 billion of equity capital each, which would still leave them grossly leveraged by *HCM*'s count.

- The Federal Housing Finance Board announced that it would increase the limit on Federal Home Loan Banks' MBS (mortgage backed securities) investment authority from 300 percent of capital to 600 percent of capital for two years. This is estimated to enable these institutions to purchase another $200 billion of this paper.

While these moves were probably necessary to save the system from complete collapse, it is abundantly clear that these drastic steps are going to have enormous negative long-term effects on the U.S. economy. Among those effects will be higher future inflation and an extension of the high levels of leverage in the system that pushed the economy to the precipice this time. Does anybody really think it's a good idea to have Federal Home Loan Banks buy more MBS paper? Or for Fannie and Freddie to leverage their balance sheets further? All of these actions are going

to have to be unwound at some point, which means that the day of reckoning is simply being delayed.[8] It is clear that the authorities are engaged in a desperate attempt at economic triage that bodes poorly for the future economic health and stability of the United States. Looked at in this context, it is difficult to argue against those who believe in long-term U.S. dollar weakness. If you want to look at the end of American economic hegemony, just look at the list of desperate actions taken by U.S. financial authorities above. It is a sad commentary on how the greed and short-sighted actions and policies of U.S. politicians and businessmen have inflicted permanent damage on our economy.

There is a way out, but it will not be easy. The way out is to accompany the drastic steps taken by the Federal Reserve and Treasury with a comprehensive regulatory revolution that addresses the flaws embedded in the system. *HCM* does not use the word "revolution" loosely, but nothing less than a drastic rethinking of our current system accompanies by action to change it is going to be required if we are to strengthen the global economic system for the challenges to come.

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[8] After rereading that sentence, *HCM* has to ask whether we are the only ones who think that it is really the case that these moves will have to be unwound or that they can be unwound. It may be more realistic to believe that these moves, such as the releveraging of Freddie and Fannie and Federal Home Loan Banks' increased purchases of MBS will remain permanent until the system can either work through its problems or collapses under its own weight once and for all. The only thing we know for sure is that pain delayed is pain increased. Failure to accompany these triage moves with substantive financial reforms will guarantee that the future pain will make the current crisis feel like a walk in the park.

Disclosure Appendix

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