Capital Drain

Rick's investment opinion newsletter August, 2007 v.3 no.7

Hi Readers,

Well goodness, it turned out to be a busy month in the markets. Even though in my previous letter I expected that things would get worse, I had no idea that they would get so bad so fast.
Yipes.

We live in interesting times.

I've got a zillion things I'd like to write, but I've tried to pick just a few save the rest for another day.

BTW, the fund is making fine progress, so there will be much more to say soon.

OK, this is going to be a long one, so get comfy. In my opinion:

Executive Summary:

- What is Liquidity?
- How Central Banks work
- What do debt ratings mean?
- Dead Banks Walking
- Behavioral Finance: Confirmation Bias

As I've written before, I think everyone is best off with a **broad diversification** that includes at least **3/4 overseas** assets (easily purchased via US mutual funds and Exchange Traded Funds (ETFs)), reflecting the distribution of world economic activity.

This is a good time for investors to be conservative, to be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

The Details:

> "Our current system of levered finance and its related structures may be critically flawed. Nothing within it allows for the hedging of liquidity risk, and that is the problem at the moment."
>
> - William H. Gross, Chief Investment Officer of Pimco[1]

Everyone lately has been talking about **liquidity**. What is it, anyway? In a personal context, liquidity is each of and a combination of:

a) Do you have the cash to pay your bills?
b) Is there someone who will lend you the cash to pay your bills?
c) Is there something you can sell quickly, for a price that you consider fair, to get the cash to pay your bills? Is there a willing buyer?
d) Can you sell the asset of your choice, something you really didn't want much anyway? Or does no one else want that asset, so you have to sell something you'd much rather keep?

In a business context the only difference is that "pay your bills" can mean a variety of different financial obligations.

The reason liquidity is in the news, then, is that different segments of our financial economy are falling short on some of those measures.

A lot of recent home buyers, for example, a) can't pay their mortgage out of current income, b) can't refinance, and c) can't sell their home for a good price. This isn't just the newly-famous subprime borrowers, either. Even borrowers with relatively good credit signed up for mortgages with low teaser rates which are resetting to higher, unaffordable minimum payments. It's a bad idea, but they could buy some time by d) selling their jewelry, etc., or raiding their insurance or retirement funds. Bad idea.

Remarkably similarly, a lot of hedge funds a) don't have cash or current income, b) have already borrowed (at least) as much as lenders will let them have, and c) can't sell the LBOed companies or CDOs and other exotic derivative stuff that they invested in. To buy time, they can d) sell assets like Treasury bills, blue-chip stocks, gold, etc., that have a ready every-day market.

Some businesses a) have a lot of debt payments relative to their income, and b) can't borrow more now that investors are a little more cautious about junk bonds. They could c) sell a division or issue more stock, but that takes time even if it works.

Some banks have lent money to all of the above. They are realizing that a) those borrowers won't repay them on time, and b) bringing in more depositors' or investors' capital is time-consuming at best. They c) can't get much of anything by selling the bad loans, but they could d) sell some of their good loans to other banks. Even selling at a loss, at least they get some cash.

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[1] Floyd Norris, " News Analysis: A New Kind of Bank Run Tests Old Safeguards," The New York Times, 10 Aug. 2007, The New York Times Company, 10 Aug. 2007 <http://www.nytimes.com/2007/08/10/business/10liquidity.html?ref=business>

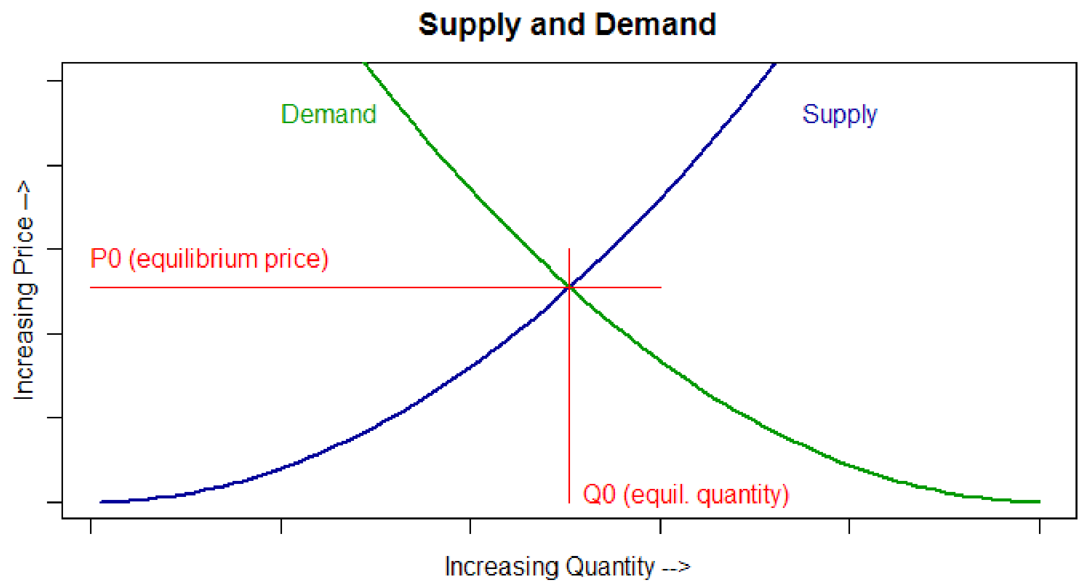
How, now, did the **Federal Reserve Bank** (FRB) and it's European, Japanese, and Australian counterparts try to fix this situation? Basically, by making short, safe, fully collateralized loans to the banks. The banks would be relieved of the need to sell anything at a fire-sale price. In turn, they could give the businesses and hedge funds some breathing room to avoid fire-sales.

How exactly, does the Fed make loans anyway? Let's start with a quick review of the central concepts of Microeconomics: Supply, Demand, and Equilibrium. (Econ-savvy readers can skip ahead 3 charts to the top of page 5.)

If you're buying something, you'll likely want to buy more of it if it's cheaper, or less of it if it's more expensive.

If you're selling something, you'll likely want to sell less of it if it's cheaper, or more of it if it's more expensive.

Buyers and sellers are called 'Demand' and 'Supply' respectively. Their price/quantity preferences can be represented as curved lines, like this:

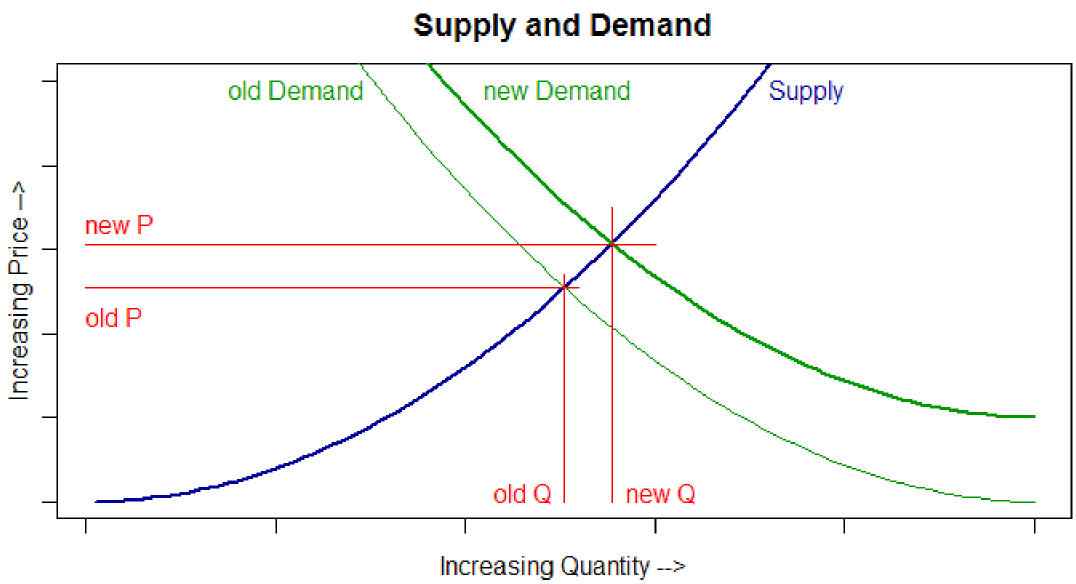


...so for example on the green Demand Curve, increasing prices (vertical rise) correspond to decreasing quantity (horizontal left), and vice versa, right?

The price where the buyer wants to buy the same quantity that the seller wants to sell is where the Supply and Demand curves cross, the Equilibrium price and quantity.

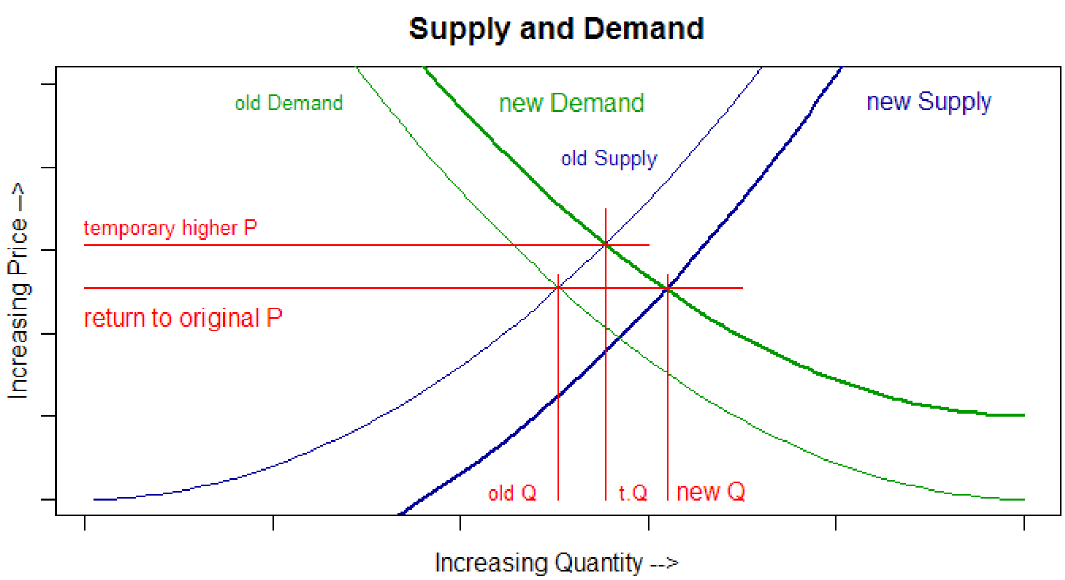
What happens when people decide they want to buy more, even if that means raising their cost a bit? That's called shifting the Demand curve (think of sliding it to the right.) Same people, same product, but now at any given price people want more of the product.

The new equilibrium price and quantity are where the new Demand curve and the (unchanged) Supply curve cross:



The supplier may now say, "Cool! If I want to, I could actually sell a lot more quantity for the same price as before!" So he makes (or picks or grows or whatever) more of the product, shifting the Supply curve to the right as well.

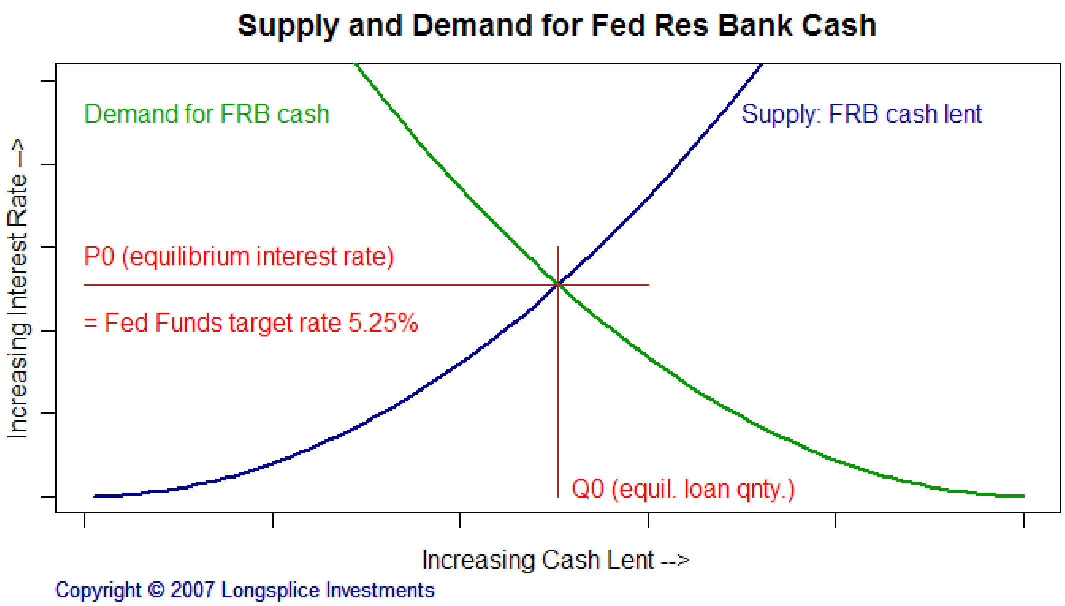
Now the new supply and demand curves cross at the original equilibrium price but a much higher quantity:



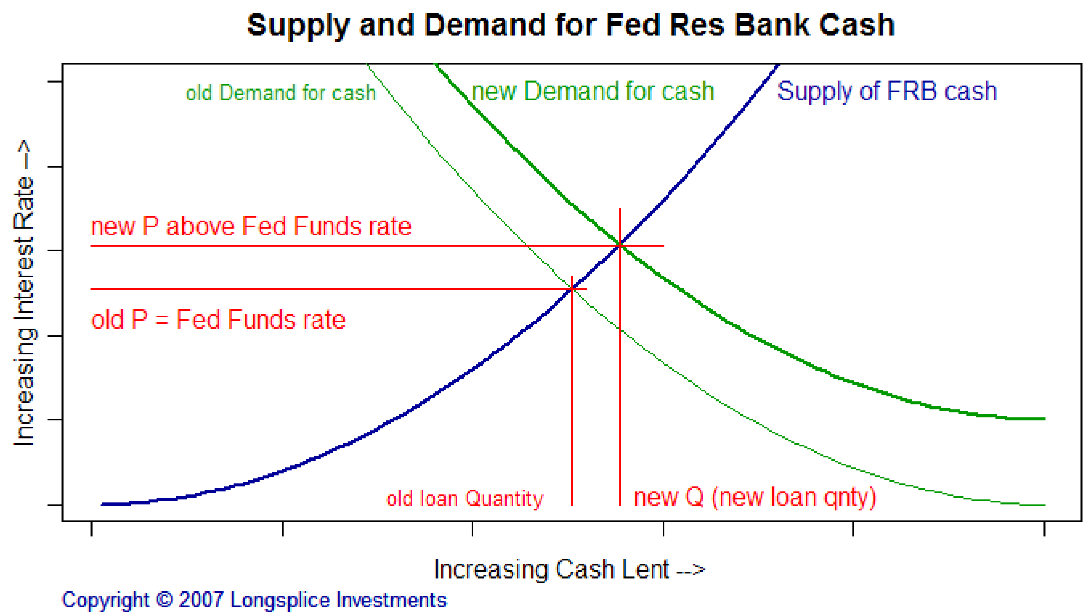
What on earth does this have to do with the FRB?

The product is cash. The FRB is the supplier. The Federal Funds interest rate is the price of borrowing cash. Bank borrowing is the demand. Here are the same diagrams with different labels.

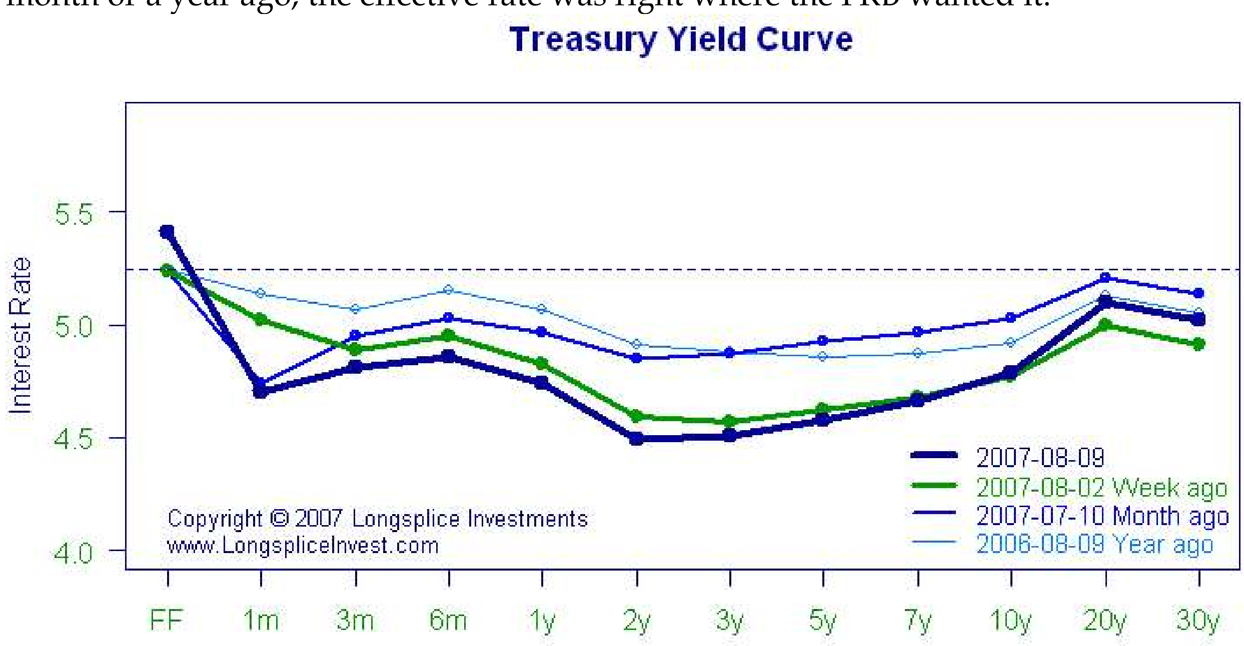
On a normal day, the demand for cash rises and falls a little based on all sorts of business details. The FRB wants to keep the price at the target rate, so it can change supply a little (for example by buying Treasury Bonds, which takes the bonds out of the market but puts in more cash.) In essence, though, the picture stays nearly static:



In the last week, the liquidity troubles discussed in this letter's first topic meant that a lot more banks have wanted to borrow A LOT more cash. Just as theory says, this shifted the demand curve and the equilibrium price rose:



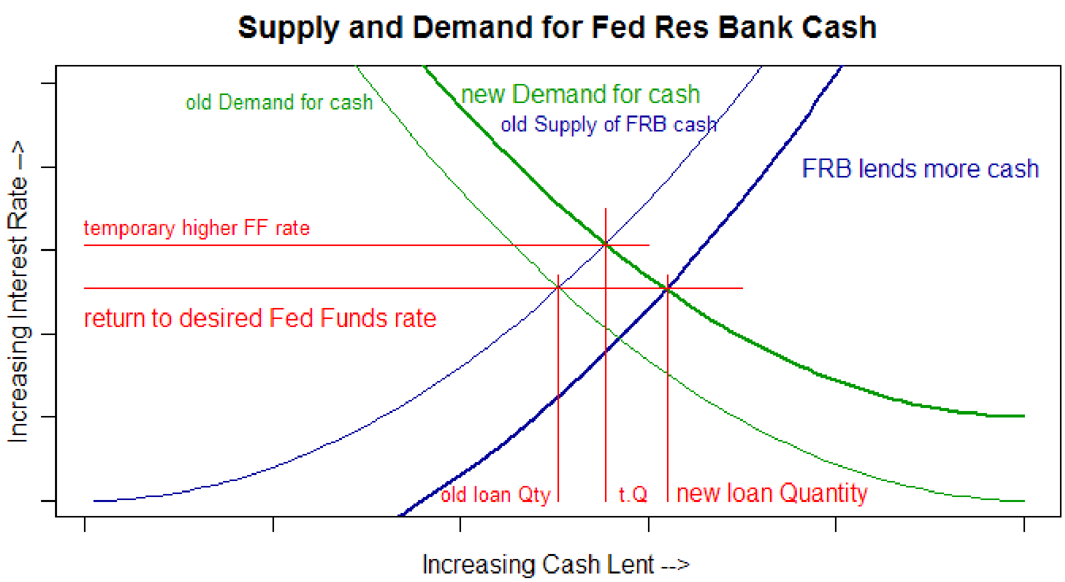
This isn't just theory, it's completely real. Here's a chart of the effective interest rates for different maturities of Treasury debt. Note that the effective (actual) Fed Funds (FF) interest rate (left, short-term end of each curve) this past Thursday was driven quite a bit above the target rate (dashed line). On normal days like a week or a month or a year ago, the effective rate was right where the FRB wanted it.



The FRB responded Friday by doing basically what they do on any day, only more so: they lent money like mad, increasing the supply and bringing the equilibrium price back to the (original) desired Fed Funds rate.

In doing so, the equilibrium quantity is now a lot higher. A lot more cash has been lent. The FRB has given the banks a big shot of (type b in my previous description) liquidity. That liquidity is expected to find its way to the banks' business and investment fund customers, (somewhat) relieving their liquidity troubles, too.

What the FRB did was slightly unusual in that they allowed bonds from Fannie Mae and other 'agencies' to be used as collateral for the loans. Further, these unusual loans were made explicitly for a short term, after which the borrower returns the cash, plus interest, and the FRB returns the bonds. The effect is the same, though.



The story is pretty much the same for the European, Japanese, etc., central banks. One different detail is that the European Central Bank (ECB) does not do this lending/re-balancing stuff every day as the FRB does. Thus, when the ECB realized that things were out of balance in Europe, they had already gotten more imbalanced than the US market usually gets. The ECB's Friday response was therefore special (by definition) and much larger (about twice as many billions of dollars) as the FRB's response. They had to play catch-up.

You can wake up now, I'm done.

I hope that explanation helped someone. No, this won't be on the Final Exam.

Let's pick up another detail to explain. You've heard about AAA bonds and Junk bonds, etc., but **what** the heck **do those credit ratings mean?**

In the bond-rating world, there's a well-accepted guideline:[2]

Investment Grade

- **AAA** : the best quality companies, reliable and stable
- **AA** : quality companies, a bit higher risk than AAA
- **A** : economic situation can affect finance
- **BBB** : medium class companies, which are satisfactory at the moment

Non-Investment Grade (also known as junk bonds)

- **BB** : more susceptible to changes in the economy
- **B** : financial situation varies noticeably
- **CCC** : currently vulnerable and dependent on favorable economic conditions to meet its commitments
- **CC** : highly vulnerable, very speculative bonds
- **C** : highly vulnerable, perhaps in bankruptcy or in arrears but still continuing to pay out on obligations
- **CI** : past due on interest
- **R** : under regulatory supervision due to its financial situation
- **SD** : has selectively defaulted on some obligations
- **D** : has defaulted on obligations and S&P believes that it will generally default on most or all obligations
- **NR** : not rated

Lower ratings are riskier, so they pay a higher interest rate to attract investors. There are only a small handful of AAA-rated US companies: GE is one example. It's huge, diversified in products and around the world, has money in the bank, and is consistently very profitable. That's what AAA means in a bond.

The ratings agencies used the same names, AAA etc., when they were rating CDOs, but clearly they meant something different. What exactly they do mean is anybody's guess and is suddenly the question on everybody's mind.

We do know that from day one the CDOs of a given rating paid a significantly higher interest rate than a bond of the same rating would pay. That implies that everyone knew they were riskier. But how much riskier?

Also, well, not everyone actually noticed that they were riskier. Many risk-averse investors, such as pension funds or endowments, have rules that say they "can invest only in Investment Grade securities." Some of those supposedly safety-first investors took the CDO Investment-Grade ratings at face value, and presumably pocketed the extra interest income without thinking about it too much. They should have known "there ain't no such thing as a free lunch," but apparently they didn't and now somebody's going to get hurt.

[2] S&P nomenclature, table from Wikipedia. I believe this table is public domain.

What can we, as individual investors, do about all this?

Be conservative.

I mentioned last month that even some respectable-looking bond mutual funds had CDOs in them. It turns out even some money-market funds had CDO-backed commercial paper. Presumably the fund managers are scrambling to fix that, and at this point I don't know that there's much you can do.

> "Bearish on assets means bullish on cash"
> - Marc Faber[3]

Don't believe the TV cheerleaders that all the bad news is out and everything is going to be OK.

There is still more bad news coming in real estate, for example. The TV is calling this "the subprime mess," but it's more accurate to call it "the variable-rate loan mess" or simply "the real estate bubble." Back when real estate was going up 20% every year, lots of people signed whatever mortgage agreement they had to in order to jump in and buy a house. Even the few who realized that they wouldn't be able to keep up with payments if the rate went up told themselves, "If the payment gets too high I can always re-finance or sell for a profit."

Surprise. Those people can neither re-finance nor sell even at break-even. As the interest-rate reset dates are reached, more and more people find themselves in a nightmare: they try to escape but they can't go anywhere.

> "The peak month for the resetting of mortgages will come this October, according to Credit Suisse, when more than $50 billion in mortgages will switch to a new rate for the first time. The level will remain above $30 billion a month through September 2008. In all, the interest rates on about $1 trillion worth of mortgages, or 12 percent of the nation's total, will reset for the first time this year or next. A couple of years ago, by comparison, only a marginal amount of mortgage debt — a few billion dollars — was resetting each month.
>
> So all the carnage in the mortgage market thus far has come even before the bulk of mortgages have reset."[4]

A lot of people are calling for the Fed to lower interest rates. I think that's just a knee-jerk reaction, coupled with wishful thinking. First, having a Fed Funds rate that's a little lower is not going to do anything to make the current situation better. Second,

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[3] "Marc Faber Says U.S. Stocks Are at Beginning of Bear Market," Bloomberg.com, 10 Aug. 2007, Bloomberg L.P., 10 Aug. 2007 <http://www.bloomberg.com/news/av/>

[4] David Leonhardt, "Economic Scene: Keep Your Eyes on Adjustable-Rate Mortgages," The New York Times, 1 Aug. 2007, The New York Times Company, 1 Aug. 2007 <http://www.nytimes.com/2007/08/01/business/01leonhardt.html?ex=1343620800&en=42ccf8d6e7d8e446&ei=5088&partner=rssnyt&emc=rss>

the Bernanke Fed read their charter, and understand that their job is to keep inflation low and employment high. Employment is still high, but inflation is still too high. I sincerely doubt that the Fed will lower rates unless the whole economy (the goods and services economy, not just the financial sector) breaks down.

> "Interest rates aren't a policy instrument to protect unwise lenders from the consequences of their unwise decisions."
> -- Bank of England Gov. Mervyn King[5]

I find it hard to imagine that, with all this trouble with people having bought junk debt labeled as Investment Grade, that there aren't some banks out there that are looking at the **possibility of insolvency**. Securities that were supposed to provide extra yield are suddenly providing capital losses instead.

It must be particularly scary right now as they realize that the (type c) liquidity for these CDOs is so bad that no one knows what they're worth now (technically zero if there's no bid), next week, or, most important, when the balance sheet closes for the next quarterly report. A lot of CEOs and CFOs are stuck between pricing based on models and assumptions, and the Sarbanes-Oxley consequences of jail time if they try to whitewash the values of their assets.

One parting thought, from the world of **Behavioral Finance**. We got to the point of this bubble bursting because once again the great echo chamber of the mainstream media said, "This time is different! No worries! Keep on, keep on!" even as the evidence of a growing problem became apparent.

People are inclined to see the news that supports the views they want to believe. It's called the Confirmation Bias; we're biased to see confirming evidence.

I wrote a nice couple paragraphs about it 'way back in November, 2005. Rather than try to improve on that, or just copying it, I refer you to: http://www.ricks-cafe.net/CapDrain/CapDrain_v1n9.pdf , top of page 3.

Well, this is the longest newsletter I've written yet, by at least a factor of two. I hope you enjoyed it.

It's time to spell-check and send.

If you have any questions, please write or phone. If you want to read more, I've got a web site (see URL below) with archived editions of this letter and some links to other interesting sites. There's also a weblog where I discuss the process and progress of starting the mutual fund.

Please feel free to forward this to any friends who may be interested.

[5] David Wessel, Joellen Perry, Monica Houston-Waesh, & Greg Ip, "Fed Issues Statement as It Moves To Reassure Jittery Markets," The Wall Street Journal Online, 10 Aug. 2007, Dow Jones & Company, Inc., 10 Aug. 2007 <http://online.wsj.com/article/SB118673195378094167.html?mod=hps_us_whats_news>

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"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare