Capital Drain

Rick's investment opinion newsletter August/September, 2008 v.4 no.6

Before printing, think about the environment

Hi Readers,

I have no doubt that you've noticed that we've had an interesting few weeks in the world of finance and investments.

For the first couple of weeks I was watching and waiting, wondering how long it would take for the credit problem to be really acknowledged as a full-bore crisis.

I wait no more. It's a crisis, and it's a big 'un. The last two weeks' events accelerated remarkably quickly, and don't let anyone tell you it's all about to be all better.

In my opinion:

Executive Summary:

- More Dead Banks
- Yes, it really is bad
- Why I think the Paulson plan is a bailout-- but could be fixed.
- Bonds. World Bonds.
- credit-check time again -- EQUIFAX

This is different from my previous few years of summary:

To the extent that you feel comfortable not "buy and hold"-ing, take some of the profits you've got in stocks. If you still have any money in high-yield (junk) bonds, sell those, as fast as you can, even if it's a loss. For a while to come cash will be king. Almost everything else is reasonably likely to suffer losses.

Short of that, 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:

> Richard Bernstein, chief U.S. investment strategist at Merrill Lynch, said each of the crises has been dealt with as a "one-off" instead of looking at the systemic problem in the credit crisis. And until the concerns with credit and the lasting impact of strained capital is appropriately handled, the backbone of the entire global economy is in jeopardy.
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> "What people still are missing is that every growth story of the last five to ten years has been based on credit. China, commodities, real estate, hedge funds, everything was a capital-intense endeavor. Global growth was the symptom of the credit bubble," he said.[1]

I started writing this letter Friday, Sept. 5. Three banks had just been quietly and professionally closed by the FDIC. Depositors were made whole, shareholders were wiped out, exactly following the usual procedure.

Then the unusual began: Fannie Mae and Freddie Mac became wards of the State before Monday.

A week later, B of A absorbed Merrill Lynch on a Sunday. Lehman Brothers filed for bankruptcy just after midnight on Monday. The US of A absorbed AIG on Tuesday.

The next Sunday, the 20th, the last two major Investment Banks in the country voluntarily converted into more-regulated, less-risky bank holding companies.

People had stopped paying attention to mere FDIC bank closures, but the demise of Washington Mutual on Thursday the 25th got the full spotlight. The usual procedure would have been to wait another day. Something must have been pretty bad to do the biggest EVER bank closure so abruptly.

Citigroup absorbed Wachovia Bank the following Monday.

Just in case you were wondering, yes, **it is really really serious**.

Having already put Fannie and Freddie into "conservatorship," meaning that the US government became their majority owner and controlled the newly-installed management, Secretary of the Treasury Paulson took another giant step. He proposed that Congress should legislate that the US Federal Government should purchase a bunch of bad debt from failing financial companies. How much debt? Oh, half a trillion dollars. Maybe a whole trillion. No one really knows. Let's compromise and call it $700 billion. Sometime later, the government could try to resell the garbage debt, and we're told that we "probably wouldn't lose much" on the deal.

1 Rob Curran and Geoffrey Rogow, "Shareholders Run, Much Like Depositors Once Did," Wall Street Journal, David Gaffen, 16 Sept 2008, Dow Jones & Company, 16 Sep 2008 <http://blogs.wsj.com/marketbeat/2008/09/16/shareholders-run-much-like-depositors-once-did/>.

The “probably” and “much” parts bothered many observers. The US House of Representatives didn't like the idea at all, and declined to authorize the program yesterday afternoon.

> ``It's ironic Paulson has become the manager of many large financial institutions,'' said Wang Jun, a finance specialist at the World Bank in Beijing. ``He will have to ask the Chinese leaders about their experience of managing state-owned assets.''[2]

There are many financiers and commentators who argue that the Paulson plan is essential, that it is the only way to prevent a monumental disaster, and that it must be passed right away, as nearly as possible in the form he suggested. To do otherwise, they argue, would hurt everyone, from the little guy's VISA card and 401(k) to small businesses, and on up. Thus, they say, do what we tell you to, and do it now.

That's really galling. First of all, we've seen this “Legislate in haste, repent at leisure” scenario before. It's left quite a painful national scar, and the Bush Administration's “trust me” quotient is roughly zero. As in the prior scenario, it's true that failure would be a lasting disaster. Also as in the prior case, that does not mean that the Administration's proposed plan has any chance of preventing failure.

Paulson proposed a bailout plan, and won't even admit it.

Taxpayers are asked to buy the bad debt, but the sellers, the reckless financial companies, are not required to pay the taxpayers back. All we'd get is the eventual selling price for the debt.

I already wrote about this on the blog, so if you don't mind I'll suggest that that you read a longer discussion of the plan at “The Big Bailout, part II”. It's deeply a flawed but fixable plan.

Sorry, but I have just one more bit of depressing commentary for the night. The media are still referring to this historic episode as “The Sub-Prime Mortgage Crisis.” That's a horribly misleading euphemism. It's much more: it's an excessive leverage crisis, a bad lending crisis, a bad debt of all kinds crisis, and now a liquidity and insolvency crisis.

Many of the past half-decade's borrowers can't and won't ever repay loans for leveraged buyouts, for corporate expansions funded by short-term junk bonds, for super-risky hedge fund strategies. When their lenders don't get repaid, the lenders lose money and some of them fail.

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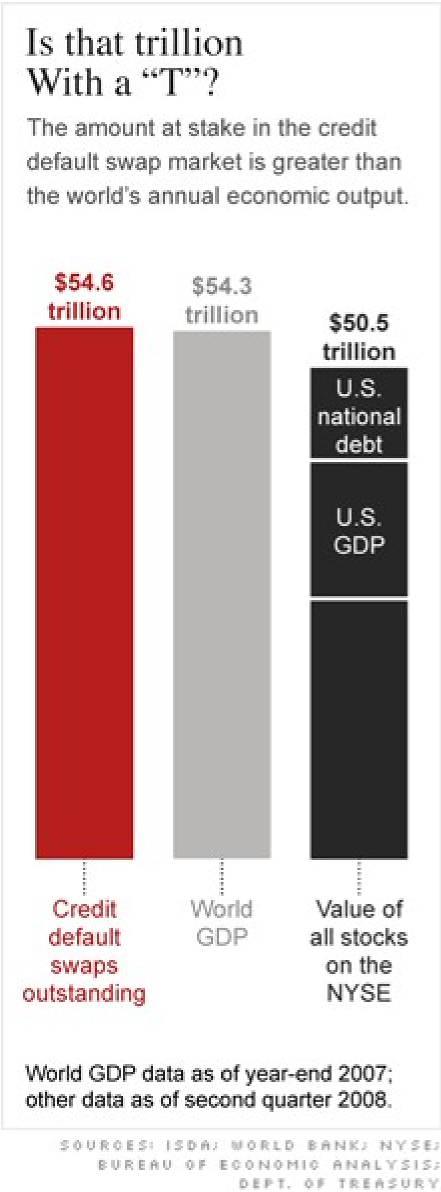
2 Zhao Yidi and Kevin Hamlin, “China Shuns Paulson's Free Market Push as Meltdown Burns U.S.,” Bloomberg.com, 24 Sept 2008, Bloomberg LP, 25 Sep 2008 <http://www.bloomberg.com/apps/news?pid=20601013&sid=aCl7bFUJzWRk&refer=emergingmarkets>.



[3]

Unless... unless... there's one more bit of Financial Magic that's supposed to save them. Credit Default Swaps (CDSs) were conceived as essentially default insurance on bonds. If you bought a bond (lent money) and the borrower defaulted (didn't pay and couldn't be forced to) then the CDS was supposed to make up your losses.

Many of the lenders who made the dicey loans knew they were taking big risks, and they quite reasonably tried to insure against those risks by buying CDSs.

So far so good.

There was no requirement, though, that you had to actually be the lender in order to buy the "insurance." CDS became a way to bet on the chances of any particular bond defaulting. In no time, the purely speculative volume of CDS purchases completely dwarfed the volume of actual bonds outstanding, and so by definition dwarfed the "insurance" volume of CDS purchases. The dollar volume of those CDS purchases is staggeringly large. (See figure.)

Even that wouldn't be so bad, except that the companies selling the "insurance" were not insurance companies, and didn't have to play by the usual prudent insurance company rules. The sellers included investment banks such as the late Lehman, and many hedge funds. Many of them do not have the capital they would need if many-- in some cases any-- of the loans they insured defaulted.

Frankly, many of those insurance claims will never be paid. Many of those lenders will actually take losses, huge losses, which they thought they'd protected themselves against. The losses will become real, many of the lenders will fail, and we'll be right back at the bottom of page three.

What does this leave the average person as **possible investment choices**? Every cloud has a silver lining, and the cloud of the credit meltdown has the one beneficial

3 Katie Benner, "The $55 trillion question," Fortune, Nicholas Varchaver, 30 Sep 2008, Cable News Network. A Time Warner Company, 30 Sep 2008 <http://money.cnn.com/2008/09/29/magazines/fortune/varchaver_derivatives.fortune/index.htm?source=yahoo_quote>.

side-effect of lowering the chances of inflation and central banks raising interest rates worldwide. That makes bonds more attractive, generally. Government bonds are a safe, if unexciting bet. Right now safe and unexciting are virtues. I still prefer a world-wide mix of first-world treasury debt, such as one can find in PSAFX or BWX.

If you have a strong stomach and can afford to watch some short-term losses come and go, gold could well rise significantly, the dollar will likely fall, and shorting (via ETFs) the financial sector or the broad market could continue to be very satisfying.

Lucky you, it's **Credit Check** time again! Once per year per Credit Agency you're allowed to get a free copy of your Credit Report. If you've been following along with my every-four-months pace, you're ready to go to Experian (again.)

It's easy, and to make it even easier I've taken notes from my own recent visit. You can follow the instructions at http://www.longspliceinvest.com/CapDrain/Equifax.pdf

It's tired, I'm late, and it's time to send this to you.

If you have any questions, please write or phone. If you want to read more, the company web site has archived editions of this letter, lots of charts, and links to other interesting sites. There's also the web log where I discuss the process and progress of starting the mutual fund, along with occasional economic or investing thoughts..

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

Take care,

Rick

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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