

I Think They Left the Piano

As of this writing (rewritten for the third time to account for abrupt market changes) “The Great Panic of 2007” appears to have subsided. We would venture to say that the ‘tell’ was on Friday, August 10th, when the Federal Reserve Bank of New York injected \$38 billion into the financial markets, which was the single largest open market operation ever conducted by the Federal Reserve, and that includes September 11, 2001. Under the heading of watch what they do, not what that say, the Fed bought \$38 billion of mortgage backed securities.

In our feeble attempt to acknowledge the green dictatorship, we will not produce four additional pages as a primer on subprime mortgages, credit cycles, the growth of the derivative markets, the yen carry trade and how they all coincided to produce the current mess. (Check prior [Letters](http://www.rcbinvest.com/resources/letters.html) at www.rcbinvest.com/resources/letters.html) But what we have just endured is yet another fascinating look at how markets work and how they don't. We will paraphrase the same Shakespeare quote for at least the fourth time in the sixteen years of this publication, “the

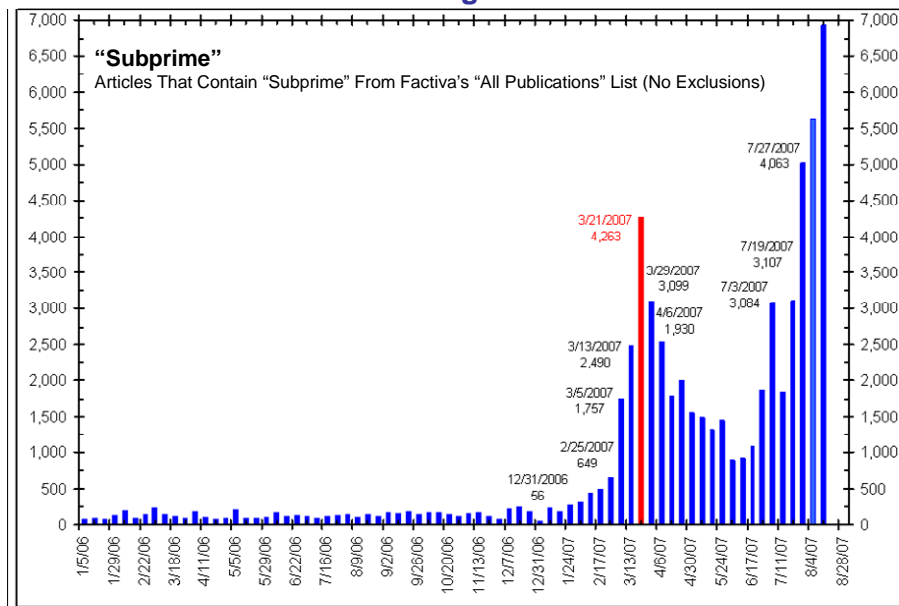
fault, dear Bernanke, lies not in our stars, but in ourselves.” The ourselves in this case are the collective global buyers, and those who back them, of the generic Adjustable Rate, Subprime, Alt-A, Pay Option, Neg Am, Synthetic Debt, Mezzanine Class C Mortgage Trust securities that are currently sucking the animal spirits out of our financial system.

Since the leading men of finance met under a Buttonwood tree in downtown Manhattan in 1792, Wall Street has existed to attempt to sell product at a profit. Given the enormous profitability of its endeavors, Wall Street does not generally waste its time trying to sell things to people who simply aren't going to buy them. But if there

develops such a laxity of prudence and common sense in an environment where the pendulum swings well into the red hot zone of capital gains greed, Wall Street will give the people what they want, and as we have documented in the last two years of [Strategy Letters](#), the last three years have been a magnificent example of this.

We have also suggested that while it pays to study financial history, the future always comes at you in a

Tell Us Something We Don't Know



Source: Bianco Research, LLC

slightly different guise. It seems impossible that we are really going to follow the same dot-com playbook from the beginning of this decade: huge amounts of money lost due to a complete lack of buyer diligence; the endurance of sheer nonsense in the *New York Times* as to who's to blame; Congressional hearings and the dutiful passage of laws to curb mortgage abuse, which have unintended and negative consequences likely to make the problems worse; and a set of terrific opportunities to be captured by those willing to endure some short-term uncertainty and our favorite, "headline risk." (The risk of being embarrassed in front of your clients versus actually losing money...bring it on!)

We would be remiss in not mentioning one candidate in the "Who's to Blame Game" that does not seem to be getting much attention. In the last ten years, didn't Congress go hog wild on the idea that our nation's financial institutions were not lending to less advantaged areas and their residents? Hearings were held, a variety of studies were put forth and defensive CEO's were put through the usual headlight-beam-interrogation in front of television cameras. The results were announcements by our largest lending institutions to commit to lending tens of billions of dollars in home and business loans to these conceptually credit blighted areas. Take a guess what kinds of loans these inevitably were and take a guess about the ensuing political mess that is coming about as these loans default and lending institutions attempt to run these loans through the usual work-out and foreclosure process. Good luck.

We are now in what we would call "The General Re-pricing of Risk," an environment where a whole host of people and institutions realize they have made mistakes in terms of the size and type of their financial commitment and are belatedly attempting to remedy this via reducing this exposure and tightening credit. We recall the headline of our last [Strategy Letter](#) "Sell to Whom?" We have seen bid-ask spreads for legitimate mortgage bonds at 75 – 95, and some of our smaller cap stocks have had consecutive 20% down and up moves in the absence of any news. The recent state of the debt, equity and derivative markets have been so fraught with bizarre inconsistencies that universities should cut their expenses by shutting down their academic finance departments who still parade around the efficient hypothesis. (Note to self: chaotic pricing is usually noted around inflection points; buy "real" high quality mortgage backed securities.)

We have noted many times in the last two years that financial markets and the history of mankind are not

records of calm seas and predictable futures; and thus the last two years of a steady upward, no correction world were an aberration, not how things should be expected to work. As an example, the S&P 500 has had 123 weeks since 1986 with 6% gains or losses, and bonds have moved more than 50 basis points 37 times in that period. Why is it that we only have Congressional hearings and front-page interviews with aggrieved investors when the market is going down?

This process has and will continue to create both second derivative and unintended casualties and opportunities. Despite some visible bruises, we have suffered no internal bleeding as we have had ZERO exposure to homebuilding, subprime mortgage players and our general financial exposure is highly concentrated in some of the largest, most balance sheet rich players like Berkshire Hathaway. But we would like to point out that despite fun headlines of Hedge Fund X closing having lost 90% of their assets in two weeks, most investors are not really suffering. Real financial pain is not giving back the gains of the first half of the year, it's actually losing 15%...or more.

So we have been doing some buying, but we are not kidding ourselves. We are marching like Sherman through Georgia into a new credit cycle of tighter credit standards across the board, and while the Federal Reserve can make money available for financial intermediaries to lend, that does not mean they will. The debt hangover in the mortgage and, as importantly, the corporate world, may take a multiple of years, not months, to overcome and restore rational equilibrium. Lenders who cannot differentiate between good and bad are unlikely to make a loan to anyone. This is not an inconsequential economic headwind, but in all likelihood, it is also not a call to stock up on canned soup and beans. Nature and the financial markets abhor a vacuum and its polar opposite, complete chaos, and as a result, "panics" don't last forever. There are lots of smart, well-funded investment types who still have jobs and look for the nearest hint of becalming markets to steel up the nerve to wade into the currently troubled waters of credit and mortgage backed complexity and start re-establishing a "market," the absence of which is legitimately scaring the heck out of people who are either presenting or analyzing financial information. The mental equivalent might be the insurance and re-insurance world: when a big storm hits, there is panic and certain players get wiped out. But new capital all of a sudden finds itself in Bermuda starting up a new company to offer very highly priced new capacity. The market eventually works...but not soon enough to keep

everyone in business, to paraphrase Mr. Keynes.

We would note that we have had decades of success trying not to invent and implement grandiose schemes of how life will work, but instead focus on the mundane tasks of analyzing securities of publicly traded companies and comparing their price with a reasonable estimate of value. The current task is two-fold – look to buy impeccable assets that have been tossed out in sheer panic, and on the other hand, carefully parse through the big problem areas to find securities where we are more than amply compensated for “headline” risk. It’s a living, and our clients do sleep reasonably well at night.

If there is anything to be learned from this summer, it’s that the biggest driver of pain and suffering in this marketplace has been mostly derived from leverage. (Shakespeare #2: “Neither a borrower nor a lender be; for loan oft loses both itself and client.”) If you have a loan of any kind that has a problem and you must take the property or company back and resell it to someone else at, say, 80 cents on the dollar, it’s not fun, but you live for another day. If you bought a stock at \$100 and it goes to \$80 first, again, no picnic. But if you paid cash and have a value that is growing 8% a year, you will live to see happier days. If you put down 20% equity on a purchase of a house, you can pretty much ride out any real estate market cycle with the exception of a 1930’s-like decline.

Now if you are levered two-to-one in a market neutral hedge fund, nine-to-one on your leveraged buyout or fifty-to-one on a piece of real estate, a relatively minor price movement like a ten percent correction wipes out most of your capital, and that is the basis of most of the headlines we see today. Subprime lending has been a highly profitable venture for at least hundreds of years. (Keep thinking Shakespeare.) It is subprime lending at 98% loan-to-value that is the new and disastrous twist.

Leverage is anathema to patience, which is required to be a value investor. “Cheap” can take a maddening amount of time to work itself out to glory as we have learned the hard way. Some of the extreme moves we have seen are the result of “must sells” either from direct pressure from lenders such as a margin call or a feverish desire to simply reduce exposure to leverage for fear of further pain. This neatly flows into the second problem with performance fee based funds – the over-riding desire not to stray far from the previous high water mark. For those who haven’t drunk the Kool-Aid, a performance fee is often based upon the

highest unit asset level reached by a fund. In other words, you can’t be down 20% and then up 20% and expect to take 20% of the profits on the second year when all you have done is claw back most of what you have lost. Compensation levels, employee expectations and firm cohesiveness are often based on the income generated from the performance fee for all but the largest firms. If you cannot reasonably earn a performance fee because you are down 15% from the high water market, people leave and firms implode. The “average” fund clings desperately to very short-term asset marks, and is prone to trade frenetically in order to maintain them. The result is a DNA oriented toward selling into down markets as opposed to buying.

So we pose the following question: are you better off in an unlevered fund that shifts assets between effective cash and a value based stock selection process to adjust capital loss exposure, or in a “market neutral” fund which on a levered basis seeks to buy the undervalued X and sell the overvalued Y in a non-transparent fashion? From the enlightened height of our self interest, I think you know our answer, and the events of the past few weeks support it. Yes, there are some people who may legitimately have “models” that can work, but assuredly not anything remotely like the number of people who are currently offering it in glossy brochures. We would also state that it is complete rubbish to suggest that in a world that mostly finds it difficult to outperform markets with actively-managed, long-only stock picking can now claim to add value by not only picking stocks that go up but neatly shorting ones that will go down more than the market.

Speaking of “models,” Goldman Sachs recently had a conference call with investors for their down-30%-in-a-week quant fund and trotted out the phrase du jour (“sorry” was #2): “We were seeing things that were 25-standard deviation moves, several days in a row...and our models didn’t pick that up.” Mathematically speaking, that means that a variety of models, managing tens of billions of dollars on leverage, predicted the price movements of August to be events that could only reasonably be expected to occur *once* every 100,000 years to longer than the Earth has been in existence, depending upon your graduate school degree. Being that wrong has got to be uncomfortable.

On that note, help us understand the due diligence process of mega-pension and endowment funds at the highest levels of institutional investing. Besides the innate contradictions in an investment “product” that

promises double digit returns with no down months, what is the investment strategy of fighting to get into highly touted funds, paying exorbitant fees and enduring multi-year lock-ups of their cash; and then fighting to get out of the same funds or their equivalents at the first hint of – cue the dramatic chipmunk (youtube.com/watch?v=a1Y73sPHKxw) – a down month? If you think you have hired smart managers who just got clobbered in a global meltdown, shouldn't you be thinking to add money?

That's what we are thinking now. We think this is the best time, since early 2003, to be giving us new money to manage, as we are in the front-end of an increasingly target-rich environment; and given the volatility, we need the cash in-house in order to take advantage of what is happening and what might be to come. We have put almost 20 percentage points of cash to work in small cap, are fully invested for the first time since 2004 and have re-opened our "SMID" strategy for the first time in 30 months. Join us in a minority view: there is an enormous advantage to being a long-only value investor in a down market versus being in a levered hedge fund.

Another factor that is setting up this opportunity is the possibility of a fading allure of value investing in the "professional" class. Contrary to investment management post-modern thinking, the concept of value investing – buying dollars for cents on the dollar – isn't everything...it's the only thing. Annoyingly in the short run, the orthodoxy of the investment management business has mostly gotten this down after the dot-com disaster and suffering through six years of underperformance in "non-value" strategies. (And no, buying beaten-down stocks formerly owned by high flying growth managers is not allocating assets to a "growth" strategy – it's what value investors have been doing!)

The now-ended mergers and acquisitions boom naturally targeted "cheaper" companies, and the momentum chasing hedge world piled into anything that even remotely sniffed cheap. To throw a little more gasoline on the fire, the proliferation of exchange traded funds enabled blind buying of what are commonly considered value stocks and value ETFs. So guess what? The cheapest 100 stocks in the S&P 500 considerably underperformed the S&P 500 index in the first six weeks of the third quarter as these worlds began to unwind, creating the effect of taking out the piano player when the panic squads raided the brothel. Now before you get any ideas, take a look at 80 years of history and note that there is nothing more concrete in academic

finance than the statement of fact that value outperforms growth over any reasonable period of time.

We admit to being modestly disappointed with our ability to give back performance since we have specifically wired ourselves in the last 18 months to stress large cap and long-term quality, but this is what gets price traction first and we are beginning to see it. The biggest risk we see is not "liquidity," however poorly defined, but the basic fundamentals. Will the credit crunch or simply fear of a credit crunch end the cycle of high corporate profitability and thus we are looking at peak corporate cash flow, which suggests that a number of values are simply not what they seem if they are based on cash flow down 25% from current levels? That's what we are watching closely; we are mostly positioned accordingly and we would be delighted to be proven unnecessarily worried. To quote the classics, "observations over many years has taught us that the chief losses for investors comes from the purchase of low-quality securities at times of favorable business conditions." -Ben Graham

We will naturally close with a final paraphrase from our favorite financial seer, who well before electricity, much less modern media exposure, noted that "*daily financial life is a tale told by an idiot – full of sound and fury, signifying nothing.*" Think long-term...and keep your TV off.

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