

## The Anti-Bubble

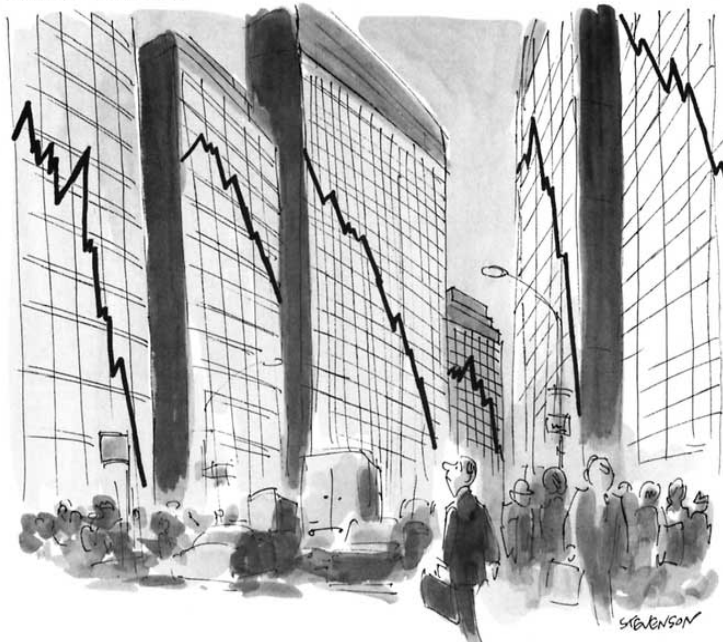
“Irrational exuberance” was a neat phrase coined somewhat ironically by former Federal Reserve Chairman Alan Greenspan in December 1996 when the Dow Jones Industrial Average was 9,600 (on its way to 11,500). We say ironically because Mr. Greenspan now seems to spend most of his free time out of the bathtub talking to the financial press in a vain attempt to improve his legacy, which many suggest has been tarnished by the idea that his easy money policies were the root cause of “irrational exuberance” in both the equity and then later housing and credit markets. © Cartoonbank.com

In the dot.com era of the late 1990s, every piece of news was good news, every rumor a reason to buy a stock, every statement by company management confirmation of what “everyone” knew - the world had changed and you had better get in before the next billionaire was on the cover of *Forbes* mocking your attempts to cling to common sense and a rational investing process.

Moving forward to the extraordinary financial mess we are living through today, we designate it “the anti-bubble.” Like a physics experiment on stellar implosion (and arguably as decipherable to most people), we seem to be in a horrible and dark vortex in which reality is folding in upon itself, making it impossible for any good news or potential good news to escape and be considered in a balanced fashion. All news is considered bad news, and just as there was no price too high to pay a decade ago, there is now no price too low to sell. The glass is not half

empty; it is being thrown angrily into the fireplace.

We don’t pretend we are calmly sitting at our computers, rationally processing what we see unfolding on a daily basis. It is not every ten days that we witness the largest bankruptcy in US history (Lehman Brothers), the shotgun wedding of Merrill Lynch to Bank of America and the de facto pre-packaged bankruptcies of Fannie Mae, Freddie Mac and AIG with the US government acting as judge, jury and banker.



Our Large Cap strategy is handily outperforming its comparative indices, while our Small Cap strategy remains locked in misery amidst its worst 12 months of performance since its inception in 1993. Our All Cap strategy is a blend of the two foregoing statements, and our freshly minted International strategy (yes, you will hear more about that from RCB) is off to a superb start versus the MSCI EAFE index, albeit a modest accomplishment considering the index’s dismal performance year-to-date. Our balanced accounts

have a conservative allocation to equities, and very importantly, have had very few misses in fixed income, allowing them to work as they should and minimize capital depletion in difficult markets.

The most obvious admission that we have readily offered in the past is that we don’t know when the pain will end, but we do know it will end as the momentum of fear is merely the polar opposite of the momentum of optimism – the same human flaws are at work. While speculative

trading and momentum based strategies have been documented in financial markets since the 17th century (tulips anyone?), they clearly have been introduced to steroids in the past few years as financial engineering has enabled the creation of more and more leveraged devices designed to take the pricing of securities farther and farther away from fundamental value – both on the upside and the downside.

In the fear of today's market, it is terribly easy to focus on price movement as the sole arbiter of an investment process. If the price is down, I am doing something wrong. But price without a determination of value with which to compare it to is like hitting a golf ball blindfolded without any idea of where to aim. An investor has to aim with some rational attempt at valuation.

Now it can be argued that we are not in a rational environment, and attempting to apply a rational process to the analysis and valuation of financial institutions is a fool's game that will end up like our dismal experience with AIG. Financial institutions are not just a rational sum of assets minus liabilities, but an equity value framed by a reference of "trust and reputation," a truism we regularly repeat to ourselves. If a management team is not trusted or a company is not seen as an accurate representation of its financial statements, it will experience "heightened concerns about its liquidity and a declining risk appetite for its funding securities." That is clearly the process on which the markets are currently choking.

While these issues exist in all institutions, financial institutions in today's world are a complex mix of equity, debt, credit derivative pricing and rating agency models and opinions. Each segment of these populations stares at the pricing outcome of each other's work and then asks itself, "What do those guys know that I don't know?" – then adjusts its pricing to the pricing of the others. So, in today's world, if a credit derivative's pricing starts to "widen," a bond holder or would be bond buyer starts to question whether they should be buying a bond with a 6% yield when the derivative security suggests something like 8% would be more appropriate. Maybe an equity holder sees this and starts incorporating a higher interest expense which then scares someone off at the margin and the stock starts to go down. The rating agency then asks itself, "why are we rating this bond an A+ when the yield is more indicative of a BB," and then cuts its rating to BB, noting "the stock price is down and the credit spreads are up" which of course sets in motion more of the pricing dynamic noted above.

This is not to suggest that many financial institutions are not having hideous problems with credit and their ratings should not be cut or their stocks shorted, but there have been some "technical issues" that have taken cyclical credit problems and blown them into a crisis maelstrom.

Our biggest pet peeve, as previously noted in this space, has been the robotic adoption of mark to market accounting. Former FDIC Chairman Bill Isaac wrote a terrific editorial in the *Wall Street Journal*, suggesting that if mark to market accounting was in effect during the 1980s, nearly every financial institution in the country would have been declared insolvent and the Resolution Trust Corporation balance sheet would have had more assets than the overall US economy. By forcing financial institutions to blindly adopt "market pricing" during a period when there are no functioning markets is inane. A system of allowing management some discretion to use "economic value" is not a hopelessly naïve idea. Over time, investors sniff out management that is conservative and award the stock of those companies a higher valuation than those that consistently overstate and under deliver. There are roughly \$1.2 trillion of subprime loans with bearish estimates suggesting an ultimate loss ratio of 25% to 30%. While a few hundred billion dollars among friends starts to add up, this is a number that could reasonably have been handled by our financial system without the cascading effects of contagion fueled by mark to market accounting excesses.

Interestingly, while all of this is going on, the US has been actively exploring the idea of dumping GAAP accounting standards, which are currently running at 25,000 pages and moving to International Standards, which are "principle" based and run 2500 pages.

This all gets back to the differences between prices and value, and the idea of financial markets as voting machines in the short run and weighing machines in the long run. An example of this we like to highlight is from a study released this month by the Bank of International Settlements (BIS) on the pricing moves of ABX indices (those based upon credit derivatives written upon mortgage-backed securities backed by subprime mortgages). With credit markets nearly frozen, it has become extremely difficult for financial firms and importantly their auditors to point to actual transactions in which to mark to market their holdings, and the ABX indices are increasingly used as a gauge for firms as they attempt to follow mark to market accounting rules.

The BIS found that the "empirical evidence suggests that observed ABX prices are unlikely to be good predictors of future default related cash flow shortfalls on outstanding mortgage-backed securities, particularly at the higher tranches," and that investors' "declining risk appetite and heightened concerns about market liquidity" are as important in determining ABX pricing. In other words, indices of mortgage credit which are now being held up as the bible of pricing for the mortgage assets of financial institutions are reflecting more the fear and panic among market participants, most of whom are hedge funds and investment banks either speculating or desperately trying

to hedge their own positions, rather than the likely actual cash losses that would occur should the underlying securities be held to maturity. In the world in which we currently operate, the voters are simply running over the weighers, and that has been the kiss of death in the uncharted waters our financial institutions are currently sailing.

It has been noted, correctly in our opinion, that it is the housing mess that began the financial crisis (thank you again, Mr. Greenspan), and we will continue to suffer until the housing prices bottom. As hard as it is to imagine, that is actually the good news. People fret that there will be \$1 trillion in mortgage losses before it is all over. That's great, because if you add the \$600 billion or so accounting and actual losses that are the current tally for the banks and brokers, and then throw in roughly \$200 billion for the insurers, GEs and GSEs, we are already within whining distance of the bottom.

The market panic has pushed Treasury yields down in a hurry and that in and of itself is reducing the mortgage interest rate reset problems that produce massive consternation. The bulk of bad mortgage underwriting was done in 2006 and early 2007, and if mortgage interest rate resets produce the same or

lower payment for borrowers in 2008 through 2010, then it does not automatically produce the massive foreclosure chain so eagerly predicted by economists, at least not as badly as feared. If the bulk of our mortgage related losses that are now producing problems were originated in 2006, does it not follow logically that on the margin the mortgage problems of 2009 will reflect only a half year of moronic underwriting standards from the class of 2007? Since subprime lending in 2008 has effectively ceased to exist, does it not follow that 2010 should be a better year for lending profitability than 2009?

It has been estimated that annual demand for houses in the US is approximately 1.3 million depending on estimates for population growth, natural housing stock depreciation and the "theoretically" correct rate of home ownership versus rental. The country obviously built too many houses mid-decade having gone through a period of constructing north of two million units, leaving us with

excess supplies. In response, the US is currently building at a 900,000 annual unit rate which will deplete the current inventory allowing for the construction rate to return to its natural level.

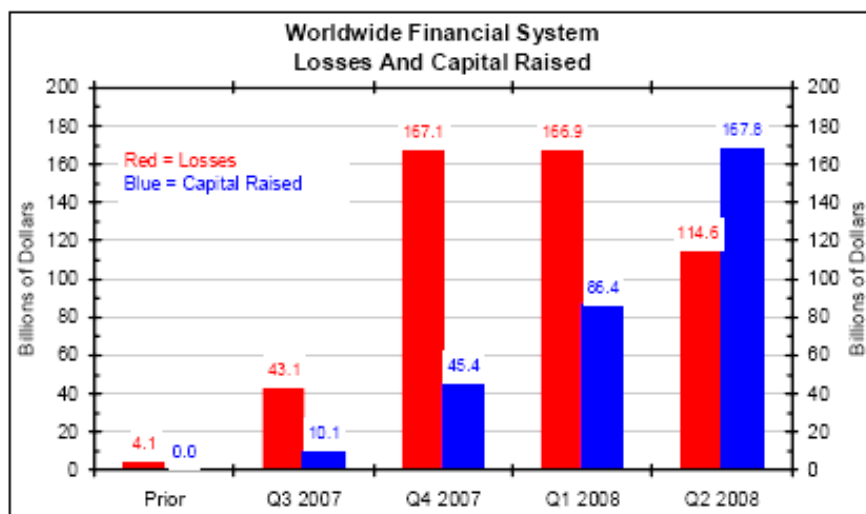
This is how the world is fixed, by a marketplace reacting naturally to supply and demand that is always overlooked at inflection points as the trend is loudly pounded home by those currently benefiting from it. Personal decorating issues aside, there are few bad houses, only bad prices. Mortgage issues will mathematically bottom out and any remaining financial institutions left standing will reap the benefit of lower credit costs and a wildly positive net interest margin environment (timing to be determined).

The mean reverting nature of markets continues despite how overwhelming any short-term evidence to the contrary. Did it seem possible 18 months ago for the private equity machine to shrivel? Was it obvious that oil would double in 12 months and then drop 40% in the last three? These examples reaffirm our belief that many who have been publicly and aggressively bearish have the same statistical propensity to be wrong as any number of "formerly" well regarded money managers with long-term track records who

have been truly humbled in past 12 months. There is no rule that unexpected surprises are only negative ones.

One big risk here is government intervention. We recommend Robert Rubin's book, *In an Uncertain World: Tough Choices from Wall Street to Washington*, to get an idea of exactly how ad hoc government intervention can be and maybe that is the way it must be given reaction times and their consequences. The Federal Reserve and Treasury Department have actually been quite inventive in dealing with these uncharted waters. But what has been demonstrated since the Bear Stearns debacle, is that unintended consequences always arise from an ad hoc process that moves infinitely faster than any pace of real regulatory reform that is rumbling down the pike. Regulatory reform, meanwhile, does not come with a guarantee of effectiveness and in fact often leads to quite the opposite (see Sarbanes-Oxley).

### The Hole That Needs to Be Filled



Source: Bianco Research

The latest Paulson Plan, announced as we are going to press, is an excellent example of this, as the plan encompassed three pages while a traditional bill in Congress would run some 2000 to 3000 pages. There will be an enormous amount of “devil in the details,” but our mental sense is that Congress is so ignorant on the topic that they will likely be steamrolled into quickly approving it. It will have a variety of safeguards that will enable them to take all the credit if it works and blame the Federal Reserve and the Treasury if it doesn’t. If the main intention of the Paulson Plan is to make it very clear the US government will put the full collateral of its taxpayers and its printing presses behind finding a solution to settle world financial markets, then it is likely to succeed in the short run as a means to grease the wheel of finance. Congratulations America, we too have a Sovereign Wealth Fund!

What is completely missed by the financial press and most commentators is this could possibly be a giant revenue gain for the US taxpayer, not a “bailout” in terms of a true realized gain/loss position. As written, the Treasury could put up far more than the headline \$700 billion, as that merely represents the maximum amount that it can put out at any one time. The Treasury could easily put up hundreds of billions for assets at \$X, sell them for \$Y and then go right back out and buy more assets. As noted above, we believe this is a great time to be a completely funded buyer of assets. If nothing else, and putting aside issues regarding the true nature of capitalism, the Treasury will be funding itself at current rates of 2% or less while yields of AAA rated non-agency mortgages are in the double digit range. This is a veritable goldmine for taxpayers, as much as it pains me to say it. The questions are: will the Treasury’s purchase price be a reasonable assessment of “fair value” or a true subsidy to the selling institution, and secondly, will the Fund hold the assets through the settling dust and thus be in position to realize profits or will it essentially be a short-term transfer agent and blow assets out through the other door at potential losses in an unsettled market. Either way, the “cost” to the taxpayers is going to be a lot LESS than what you are reading in the headlines.

Another plausible outcome of the Paulson Plan is that the government doesn’t actually get to spend \$700 billion. If the “market” senses there is a floor, there are hundreds and hundreds of billions of dollars presently cowering in the corner earning 0.15% that will be enticed slowly, and then with great force look at higher yielding assets. This will flow outward from agency bonds into perfectly reasonable cash paying prime mortgage bonds to very reasonable investment grade debt and eventually into the truly whacky stuff that has petrified the world, and voila, private money starts to do its job and outbid the Treasury. This is not an overnight process, but markets move on changes at the margin and this clearly represents enormous change.

So we are clearly stuck today between attempting to recognize the true tectonic changes occurring in the world financial environment that will seem blatantly obvious in retrospect and the age old problem that the future is uncertain and cannot be predicted with any reasonable and consistent accuracy with which to base a long-term investment process. There are many inexpensive stocks that with the benefit of a long-term time horizon should, and are being prudently purchased. The pain, however, is tangible when we start to buy a stock at \$60 that has fallen from \$100 and we determine to be worth \$90, but is merely on its way to \$40 first as the voters are just beating the weighers like a gong in the midst of a financial panic.

The majority of the companies we own whose stock has gone down in price have underlying businesses whose fundamentals have not changed materially and are simply being impacted by the timing of the economic cycle, leaving us to benefit from their rebound potential. We continue to cull mistakes from our portfolios and take advantage of opportunities provided by this sloppy market to upgrade business quality, but also recognize that what produces a significant turnaround in future performance is often exactly what penalized it in the prior period. This being said, we feel it is apt to end with the Horace quote found on the opening pages of Ben Graham’s *Security Analysis*: “Many shall be restored that now are fallen and many shall fall that are now in honor.”

*Jeffrey Bronchick, CFA*  
*Principal & Chief Investment Officer*  
*jbronchick@rcbinvest.com*  
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*The opinions expressed herein are those of Reed Conner & Birdwell and are subject to change without notice. Past performance is not a guarantee or indicator of future results.*