September 21, 2008

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

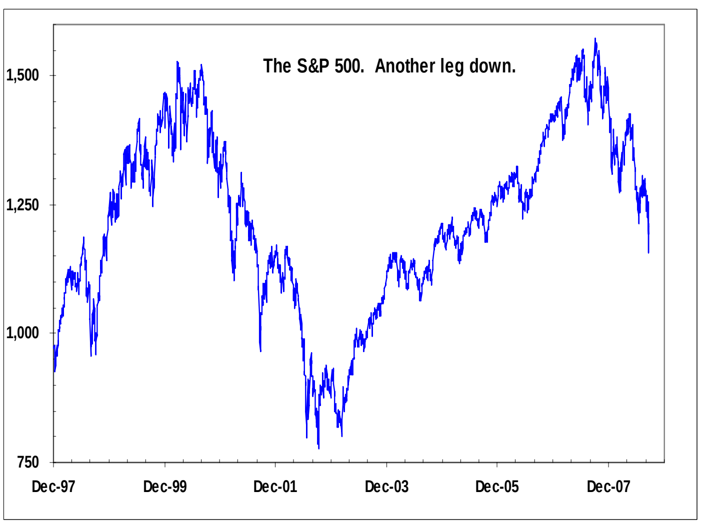
Extraordinary Events

The 2000 to 2002 bear market and the one unfolding now are depicted below.

The Fed and the Treasury have tried to draw a line under this one. Will the line hold?

I write on Sunday, after a week that will long be remembered by participants in financial markets and the banking system. It scarcely makes sense to review the events of the last month, because, as we have learned, everything may change over the next few days.

The unraveling of the financial system over the last few weeks threatened chaos and global economic recession. The Federal Reserve and the US Treasury Department took a series of enormous policy decisions to forestall these dire consequences. Financial markets around the world endured the most volatile trading in memory. Losses in financial markets and to investors in them have been enormous.



As of the end of trading on Friday, September 19, Core's client accounts in the aggregate had achieved small gains in the recent two weeks of turmoil. Of course, we show losses for the year to date, significantly smaller than the losses in the world's stock markets. We have acted with the sole aim of protecting your capital. We will stay very close to the markets. There will certainly be more volatility, more bouts of fear and intense selling, and more rounds of sharp rallies. Our view at present is that the financial crisis was not resolved on Friday. We will continue to invest to preserve your capital and to prepare for the bull market that will follow all this.

How Did We Get Here?

It is worth reviewing how we find the financial system in such a crisis, particularly since it now appears that the federal government and the Federal Reserve will be running things in banks and on Wall Street for some time. The financial system that has prevailed for the last generation came to an end in the last month. Congress, in its negotiations with Treasury and the Fed, will now determine what replaces the old system.

By

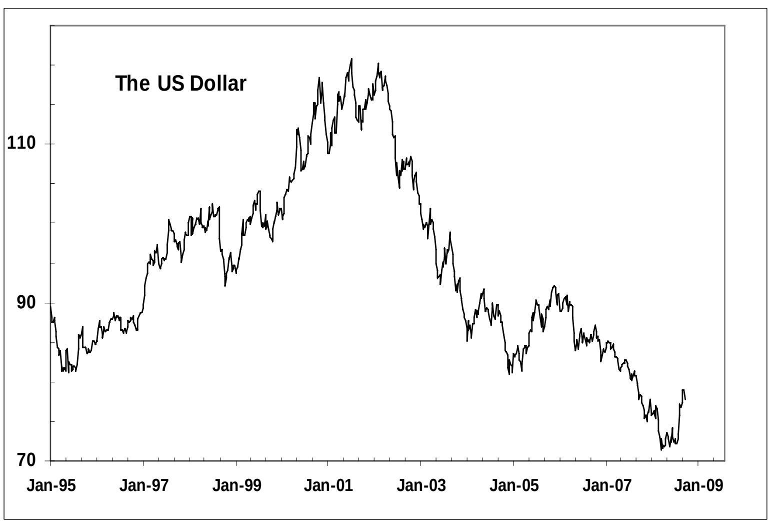
John N. Mayberry

As Treasury takes $700 billion of mortgage-related assets onto its balance sheet, the Fed will issue new dollars to pay for these. How will this new, enormous supply of dollars affect the value of the dollar?

The government plan could enhance the dollar's value: the argument is that the Treasury's plan may resolve the underlying problems in the United States relatively swiftly, leading to better US economic growth, and to our ability to attract foreign capital.

Three factors. Interrelated. Three strands of activity have come together in the last 30 years to bring us to this pass. Without giving priorities to any, they are: (a) securitization of mortgages and other species of "financial engineering", (b) a public policy to deregulate the financial system, based on the view that the private sector can handle all this better than can the government, and (c) an utterly screwed-up compensation system on Wall Street. In what follows, I will attempt to describe these and show how they worked together to create such a baleful result.

In the 'old days', banks loaned money to people in their communities to finance their house purchases. The banks made these loans in the expectation of collecting interest and principal payments until the homeowner had paid off the mortgage. Because the banks put their own capital at risk in making mortgage loans, they were interested to know whether their borrowers could meet the monthly payments and pay the loan back. Things began to change in the 1970s, when the banks that created the mortgages could then sell them on to entities like Ginnie Mae, Fannie Mae, Freddie Mac ('the Government Sponsored Entities" or "GSEs"), and, more recently, to investment banks like Bear Stearns and Lehman Brothers. The banks or the GSEs would 'package' many mortgages into various pools and sell these to pension funds and other large investors.



With this, the business of the local banks changed: instead of lending their capital for the long term in exchange for monthly interest and monthly principal repayments for a period of 30 years, the banks became "originators" of mortgage loans. When they sold these mortgages to the GSEs or investment banks, they received a fee for their mortgage "origination". The creditworthiness of borrowers was no longer an issue because the mortgage loans did not stay on the books of the bank making the loans.

"Securitization" of mortgages was the first step in a 30-year process of creating ever more complex contracts relating to financial obligations. There is not room in this letter for a full explanation of the evolution of this, from mortgage-backed securities, through interest-rate swaps, to the ever-more elaborate contracts in an ever-broadening range of investment instruments. As it happens, I began my working days as a lawyer at Cravath, a New York firm rather deeply involved with the securities industry. Cravath was the principal outside counsel for Salomon Brothers, now long subsumed within Citigroup, but then an independent investment bank of the highest standing. With other young lawyers at Cravath, I worked on interest-rates swaps for Salomon as these derivative instruments were being created. Move forward twenty years.

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Warren Buffet warned us several years ago that securities derivatives, which early in this decade were already involved with trillions of dollars around the globe, were the real weapons of mass destruction. Destruction is now being wrought.

But, back for a moment to the early eighties. As we turned the corner from the post-Depression era and the disastrous runs on banks, from the second World War, from the civil rights movement, from the Vietnam War, and into the Reagan era, our country decided that the private sector knew far better than the government how things should be run. Public supervision of important elements of our society gave way to deregulation. This was not merely the ideology of the Republicans: during Bill Clinton's presidency, the Depression-era law separating commercial banks from investment banks was repealed. Bob Rubin, Clinton's highly esteemed Treasury Secretary, was hired away from his job as the chief executive of Goldman Sachs to work in Washington. In the fullness of time, Hank Paulson followed him as the head of Goldman before Bush hired him to run Treasury. Over the last decades, under Democratic and Republican administrations, public regulation of mortgage underwriting gave way to "self-regulation" by the mortgage originators and the packagers of these mortgages.

One might characterize this as putting the hen house in the care of the fox.

The third strand of all this havoc involves the way in which Wall Street compensates its employees. Annual bonuses account for most of the compensation for investment bankers. Their bonuses are determined by the money they bring in the door in the year. Their incentive is to book fee income, from buying, packaging, and selling on to others various--and sometimes dodgy--mortgage-backed securities. If bankers sell a lot of this stuff in a given year, to continue with our example, they earn a big bonuses at the end of that year. The rub is that the fee income is booked and paid out as a bonus in the year in which the mortgage pool is sold. In 2007 and 2008 it became clear that many such securities were not worth the 100 cents on the dollar for which they were purchased. As the housing market has fallen, the mortgage-backed securities fell as well. Depending on the leverage involved in these pools, a 5% default rate in the mortgages within the pools might cause a 50% or more decline in the value of the $100 million piece of paper. Whoops. If the mortgage pool had been created in 2005, let us say, the genius who sold it to another bank or pension fund was paid the bonus "earned" in 2005 and the investment bank that underwrote the security booked its "profit". But, in 2008, let us say, the loss arose. Will the banker who sold it and was paid a nice bonus pay back the bonus to help compensate for the loss? Umm. Doubtful. But the holder of the security will book a big loss. And, because Merrill, Citi, Lehman, Bear and other improvident bankers kept a lot of these securities, either willingly or because they could not sell them as fast as they created them, some banks have been obliged to recognize losses sufficient to put some of them out of business.

The compensation problem is that fees and "profits" for creating these (toxic) securities were earned at the beginning, but the losses only became apparent recently. (Again to quote Buffet: when the tide goes out, you can see who has been swimming naked.)

Where next?

This is a monumental crisis, but it will be resolved. Housing markets will become stable. The US economy will grow. Financial markets will adjust to the very great changes and a new bull market will begin.

We will continue to guard your assets through this turmoil and prepare for the bull market that lies ahead.

Had public policies about underwriting standards continued after the eighties, people without income to repay home loans would not have been able to borrow. Had the system of "securitizing" mortgages not been used to remove from the lending banks the mortgage loans they made, mortgage lenders would have been much more careful in their lending. Had the compensation system for bankers been aligned with the ultimate value of what they created and sold, there would not have been incentive to package and sell mortgages that would have a high rate of default in future years.

So now, in September 2008, we have come to the point at which the Treasury and the Fed must take on to the balance sheet of the United States a lot of really ugly mortgage-backed securities in order to keep the banking system functioning, in order to prevent the market for stocks and bonds around the world to fall into a black hole, and in order to prevent a very severe global recession. In the week ahead, Congress must determine how this is to be done, and must make a beginning on a new system to re-regulate big aspects of the banking and securities industries.

Unanswered questions. Will this rescue plan work? Its predecessors in the last year have failed. The United States must now borrow hundreds of billions of new dollars. Will foreigners take these new dollars? If so, at what price? In July, the last month for which the Treasury has provided data, foreign investors sold or withdrew tens of billions of dollars of US securities; before this, monthly purchases and capital inflows averaged around $100 billion per month. Ominous. On Friday, the SEC banned for a period short selling in hundreds of financial stocks. What unintended consequences will flow from this substantial disruption in general market activities?

The answers will be revealed in time; we will continue to tread very carefully as we await these answers. We have recognized the problems in the housing market for several years, although we did not know how things would unfold--no one did. Our steps to limit risk kept losses at a far lower level than in the general markets. Your accounts are in a strong position; we intend to keep them strong.

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