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"Keeping your Fish Tank Clean"

I had dinner recently with my good friend Stu Berkowitz - owner of a fine local pet store named "Fin & Feather." Stu also installs and maintains fish tanks throughout the Southern Berkshires: if you see a tank full of colorful fish in a local restaurant or business, it is likely one of Stu's.

Customers often come into "Fin & Feather" and wander up and down the aisles admiring the 20-25 tanks each filled with beautiful fish. Once in a while, one will finish their circuit and approach Stu with a solemn look saying "you have a problem, there's a dead fish in that tank over there." Stu will ask, just as seriously, "what about the rest of the fish?" To which the customer will reply, "they all look great!" Stu then scoops out the dead fish, checks to ensure the filter is working correctly and the water is clean and says "no more problem."

Stu is meticulous in maintaining his tanks, but imagine if he let things slide with a few of them and they became polluted; with many dead fish floating on the surface. What if, compounding this, all the tanks shared the same water filtration system – gradually, all the tanks would become polluted and then Stu would have a big problem!

This is basically where the financial system in the United States was in the summer of 2007. Beginning with the administration of George H. W. Bush, we embarked on almost two decades of government initiatives to make home financing more available to lower income families (1). Home ownership was increasingly viewed as an American right, not just a privilege. Bill Clinton, the humanist, shared and promoted this view and George the second followed suit. Gradually, the government went from encouraging the government sponsored enterprises Fannie Mae and Freddie Mac to be more loan friendly (2), to enacting legislation to ensure they were (3), to the advent of "low money/no money" down mortgages, no credit checks and "liar loans."

Banks packaged these loans into collateralized mortgage obligations (CMO) and collateralized debt obligations (CDO) which often received ratings predicated on the vast majority of the individual mortgages being of higher quality than they really were, thus earning an A rating when they really should have been a B or lower. Credit default swaps (CDS) "insured" against mortgage default and the housing market boomed. The icing on top was tremendous financial leverage - commercial banks went from 10:1 leverage (lending $10 for every $1 on their balance sheet) to 20:1, investment banks went from 20:1 to 30:1 and hedge funds hit 100:1 leverage in some cases.

All these players were swimming in the same pool: drinking from the same trough: polluting the water that kept them alive; and when the dam burst it was catastrophic. The cascade began in the fall of 2007 and the initial reaction of George W. Bush was to stimulate the economy: the fed began to lower interest rates aggressively and, in the spring of 2008, millions of American's received a tax rebate in the form of a check in the mail. Unfortunately, this did nothing to attend to the underlying problem: the credit market was toxic and needed fresh water in the tank.

In the summer of 2008, Treasury Secretary Hank Paulson proposed the public-private investment program (PPIP) designed to buy toxic assets from the banks to cleanse their balance sheets and enable them to operate in a relatively normal fashion – bank lending makes the economy go round so this was an important objective. Under the program, PPIP would buy the bad assets and then auction them off to be worked out by private investors over time. This would create a new mechanism for trading financial "derivatives" which commonly transact privately between one bank or hedge fund and another. One of the challenges arising from this illiquid market was, and is, the difficulty in valuing the troubled assets.

In an effort to determine what their balance sheets (and capital ratios) really looked like, banks began writing down the value of many of these instruments creating a spiraling new problem: according to FASB rule 157 (mark to market or fair value accounting) positions are required to reflect the price that would be received for an asset sold in an orderly fashion. Since there was no active, "orderly" market, prices were marked down as though they were in liquidation regardless of long term value and, many argued, this led to unfair, distressed pricing. Credit markets froze and PPIP could not be enacted quickly enough to save the financial system.

At this point, Paulson and Co. concluded that something had to be done to immediately recapitalize the financial system – add some fresh water – before there was a 1930's style run on the banks. The solution was TARP, the $787 billion troubled asset relief program. This initially took the form of a direct infusion of capital to the nine largest U.S. banks and on October 14, 2008 Paulson announced the Treasury purchase of $250 billion of preferred shares in those banks under the capital purchase program (4). TARP was actually a series of acts designed to stabilize the financial system (5) and set the stage for raising private capital to repay the public money used to "bail them out."

The mechanics of this were, of necessity, complicated and imperfect. However, the result was much as intended: by the end of 2009 banks demonstrated they could raise private capital to replace public money and the majority of TARP funds were repaid with interest.

The lending environment is still slow – on both the demand and supply side – but normalizing, and bank discipline is much better than it was prior to the crisis. We still need to create a transparent clearing market for the $600 trillion of OTC derivative's outstanding which can be effectively monitored and regulated and we need to ensure that the bank's tank's; their capital base, the integrity of their balance sheet, are separate and secure so they cannot ever again pollute one another's "water of life" and endanger the entire financial system.

The crisis work has been done and financial market's have enjoyed a strong rally from the lows established in March of 2009 – we used all the dead fish to fertilize the garden and flowers bloomed quickly. Now we are emerging into a summer garden requiring more pruning, weeding and vigilance. However, we have survived the "lost decade" for equity investors: only the fourth period since the civil war during which financial market's provided negative ten year annualized returns, and the new cycle is likely to be much more rewarding. I hesitate to say, "*come on in, the water is fine*", but money is beginning to once again seek return on capital not just return of capital and that means better investment performance, for those who are patient, over the next several years.

Regards,

Terry

Notes:

1. Many factors fueled the speculative boom and bust of the housing market in the ‘90s and “aught”: sub-prime mortgages, adjustable-rate mortgages (particularly as they reset), predatory lenders, overextended borrowers, overbuilding the housing stock, inaccurate credit ratings, too much consumer, corporate and government debt in general.

2. Government sponsored enterprises were established to act as financial intermediaries assisting lenders and borrowers primarily in housing and agriculture. They have also created secondary markets by guaranteeing and securitizing loans thereby increasing loan volume on the part of primary market debt issuers. Originally, 12 federal home loan banks were established in 1932, then the federal national mortgage association (Fannie Mae) was created in 1938, the federal home loan corporation (Freddie Mac) in 1970 and the government national mortgage association (Ginnie Mae) in 1968. Sallie Mae (targeted at education) was chartered by the government in 1972, but went fully private in 1995.

3. In 1995 in an effort to push home ownership down the income scale, the department of housing and urban development (HUD) set a goal that called for 42% of mortgages purchased by Fannie Mae and Freddie Mac be issued to borrowers with household income below the median in their area. This goal was raised to 50% in 2000 and 52% in 2005. Ultimately, in September of 2008, unable to make good on their guarantees, Fannie and Freddie had to be placed in a conservatorship effectively nationalizing them.

4. The large initial recipients of TARP were: Bank of America (now including Merrill Lynch), Bank of New York Mellon, Citigroup, Goldman Sachs, J.P. Morgan Chase, Morgan Stanley, State Street and Wells Fargo.