HOW TO KILL A HYDRA
MARCH 2008

In Greek Mythology the Hydra was a fearsome water beast that had multiple heads, poisonous blood and breath. The Hydra guarded the passage to the Underworld. When a warrior attacked the Hydra and was lucky enough to sever one of its heads, another two grew back. The current subprime/financial situation that the economy is in reminds me of the fearsome Hydra. Every time a problem seems to be dealt with a couple new problems pop up. We have a good idea on how to go about slaying the mighty Hydra, but first, everyone needs to understand the beast.

Origins of the Beast

Mr. Smith wants to own a home. Unfortunately, due to some missteps and financial problems in his past, Mr. Smith has poor credit. He also did not have the funds to put money down. After hearing an advertisement on a local sports radio station he realized that he too could own a home. ***NO MONEY, NO CREDIT, WE DON"T CARE! Come on down to Easy Money Mortgage.***

Easy Money Mortgage cuts Mr. Smith a sweetheart deal where he puts no-money down with a low interest rate for three years with a rate reset three years later. Mr. Smith gets what he wanted, a nice new house and Easy Money made a sale.

Easy Money then goes to an in state lender to get the funds. This local lender gets the money by offering short term debt to investors.

Easy Money then sells Mr. Smith's loan to Mr. Big Investment Firm, (Bear Stearns, Merrill Lynch etc.), where it is sorted with thousands of others into separate groups based upon credit worthiness. The mortgages were then packaged together and sold to pension funds, insurance companies, municipalities, accredited investors, and governments.

These purchasers were supposed to know that these instruments carried a higher than normal level of risk. *"But they paid out really well and they did pay for our dinner and took us golfing in the Bahamas so...why not? Let's go for it."*

Three years later...

Mr. Smith's mortgage rate is reset at a higher rate, and he realizes that he has taken on much more than he can handle. The houses in the neighborhood are for sale and the value of his home has dropped in value, to where he owes more than his home is worth. Mr. Smith never put any substantial money down, so he essentially has zero equity in the house. He tries to go to speak with Easy Money but finds that they have gone out of business.

Notice that everyone in this scenario felt that they could get something for nothing. The home buyer thought that he could get a home with no money down, and interest rates would never rise. The mad dash for fees threw any form of reasonable risk management out the window. The investment banks that are still holding on to toxic waste paper, and did not hedge their position, have been whacked. The buyers of the paper, are of course feeling the pain, along with the shareholders. The economy and public at large is affected due to media's influence in whipping Armageddon scenarios. Actually Mr. Smith makes out pretty well. For all intents and purposes he turns in his keys and rents an apartment. He never had any equity anyway.

Comparing this Beast with other Beasts

As an active observer of the financial markets, it frustrates me on how frequent investors are separated from their assets under the promise of outperforming returns. The current subprime

situation is giving me a wicked case of déjà vu. Does not anyone recall the savings and loan crises of 1991-1992? Do you remember the Resolution Trust Company selling off thousands of foreclosed upon properties? Jane Bryant Quinn wrote a cover story for *Newsweek* to the effect that home prices were now so far below mortgage balances that if banks wrote the collateral down they would all be instantaneously bankrupt. Conventional wisdom had Citigroup going under.

It never happened. Things were not as horrible as the media was making them out to be. Citigroup was bailed out in the 1990's by the Saudi Prince Alwaleed, who recently, once again gave them another capital injection. Remember Enron? We were told that Enron going under was going to send shockwaves through our economy by going under. In reality, the K-Mart bankruptcy was a much bigger deal.

I still cannot believe how Americans could fail to recognize that lending money to credit-unworthy individuals wouldn't lead to big trouble. What do you think would happen when people were going out and buying multiple pre-construction condos with little or no money down, to flip? Never underestimate the power of denial. I had Real Estate agents cold-calling me a couple of years ago, pitching me on how Florida real estate was *"different"* and could never go down.

Sorry Mr./Mrs. Real Estate agent, I don't drink that flavor Kool Aide.

Unfortunately, many American's did, had, and will again, in the future. We shall call this Kool-Aide flavor *"Lifestyles of the Rich and Famous"* This flavor is different from the death inducing cyanide infused Jim Jones variety: It tastes really sweet going down and post ingestion causes suspended belief in gravity, Econ 101, and an inability to deal with reality. This flavor was very popular a decade ago, during the Dot Com boom, and all other financial bubbles throughout recorded history.

Think about it...America built an entire industry on lending capital to individuals who could not pay it back. Mr. Gump sad it best... *"Stupid is as stupid does."*

<u>Building the Beast</u>

We have stated previously that it is our belief that the term *"financial engineering"* can be equated with magic. The modern day magicians are none other than investment bankers that can make risk seemingly disappear. Over the past several years, as home prices skyrocketed and mortgage lending boomed investment bankers would use their magical powers to package trillions of dollars in loans, selling them off to return chasing investors all across the globe.

I feel that the magicians, over time, started believing in their own magic. They figured that their abilities would disperse risk and possibly make the markets even stronger or maybe even safer. *The Wall Street Journal* describes one such magical vehicle entitled Norma.

Norma CDO I Ltd., was a brand spanking new breed of mortgage investment. Unfortunately, rather than spreading the risk of a global home-finance boom, the instruments have magnified and concentrated the effects of the subprime-mortgage bust. Currently they are the vehicles behind tens of billions of dollars of write-downs at some of the world's largest banks. Interestingly enough, Norma was created at the behest of an Illinois hedge fund looking to gamble on subprime mortgages. The magician behind Norma was none other than Merrill Lynch.

Ann Rutledge, a principal of R&R Consulting, describes Norma, *"Everyone was passing the risk to the next deal and keeping it within a closed system. If you hold my risk and I hold yours, we can say whatever we think its worth and generate fees from that. It's like creating artificial value."*

CDO's have been in existence since the 1980's. They historically have been a package of income derived from various sources such as bonds and derivatives. A mortgage CDO would own many mortgage bonds which contained thousands of mortgages, thus allow the owner

diversification and avoidance of default risk. Norma, like thousands of other new CDO's, relied upon subprime mortgage loans.

This new market was quite lucrative for Merrill Lynch who happened to be the top underwriter for CDO's from 2004-2007. Merrill generated hundreds of millions of dollars in profits from assembling and distributing CDO's backed by mortgages. The typical billion dollar CDO earned Merrill $15 million in fees. This business was so lucrative that the white–shoe firm actually went on to recruit former penny stock salesman to sell their wares, as was the case with Norma.

From the *Wall Street Journal*, Merrill and the former penny stock outlet N.I.R. *"produced a 78-page pitchbook that bore Merrill's trademark bull. Inside were nine pages of risk factors that included standard warnings about CDO's. The pitchbook also extolled mortgage securities, which it noted have historically exhibited lower default rates, higher recovery upon default, and better rating stability than comparably rated corporate bonds."*

The Beast and Bear Stearns

This Bear Stearns debacle has left me conflicted on whether the Fed and the government did the right or wrong thing. There is a constant stream of information that is still coming out regarding this entire scenario.

I learned of the Bear Stearns debacle/J.P. Morgan buyout from my Blackberry, while getting some ice cream with my family on a Sunday afternoon. I almost dropped my cone...$2 a share. In the spring of 2007 when the mortgage and subprime crisis was just getting off the ground and Bear was beginning to have some serious trouble with some hedge funds, I mentioned that I couldn't understand how Bear Stearns was going to go forward and make the type of money it had in the past. They were heavily involved in the creation and sale of CDO's, like many other banks with not nearly the diversified portfolio of businesses like Goldman or Lehman. I made a similar call in this very Newsletter in 1999 about a now infamous Houston energy company. Basically I didn't understand how they made money. However, this situation was much different than Enron. It reminded me more of Arthur Anderson.

Arthur Anderson was one of the big five accounting firms that happened to be involved with auditing Enron. Arthur Anderson, in my opinion, was taken down and put out of business to satisfy the blood-lust of the American people. The bottom line is someone had to pay, and fast. The trials of Ken Lay, Fastow and Skilling would take too long. Bear Stearns, also in my opinion was to be thrown into the volcano to satisfy the financial gods and calm the natives.

One part of me feels that if the clients of Bear Stearns no longer felt confident in the company and decided to rush to the exits, then Bear should have gone bankrupt. It would have been painful. The market would probably have crashed 1000 points or so before the savvy vultures swooped in and started doing what all intelligent investors should do. Nicole Gelinas writes in The Wall Street Journal, *"The bankruptcy would have been painful, sending new waves of distrust through the financial system and likely forcing Bear's counterparties to book reserves for losses. But even in a world of bad choices, there's always a worst choice. And the Fed, by being so quick to jettison the bankruptcy process, cut off a valuable source of new information to financial markets and blurred the critical distinction between sophisticated and unsophisticated investors."*

The other part of me...

I was opposed to the elimination of the Glass-Steagall Act in 1999. This broke down the wall separating commercial and investment banks. I felt that eliminating this depression era piece of legislation would lead to enormous conflict of interest that hurt the investor/consumer. Unfortunately for Bear Stearns, the Federal Reserve never changed it's discount lending policies after repeal, whereas the Fed was only able to make loans to commercial banks like Bank of America and JP Morgan Chase, and not to investment banks like Bear Stearns and Merrill Lynch. The Fed started increasing it's lending to banks back in the summer of 07. However, those funds

did not work their way down to the investment banks as designed. The big commercial banks held on to the cash and used it for their own businesses. Economist Larry Kudlow contends, and I agree, that if the Fed had actually changed it's discount policies to reflect the post Glass-Steagall period, Bear could have accessed short-term Fed loans.

I understand the desire of the Fed and the governments concern regarding systemic risk and a possible tsunami to the financial system. However, I also feel that if the Fed and government set the precedent of being a backstop to the financial world, what is going to stop firms from engaging in equally risky if not more so down the road?

Was this a professional hit? *Fortune Magazine's,* Roddy Boyd, reported on April 1, 2007 this interesting tidbit of news...Several days before the collapse, Goldman Sachs decided to stop backing up Bear Stearns derivative deals and e-mailed its decision to it's vast hedge fund clientele, which in turn spooked the hell out of the markets. On Tuesday March 11, Goldman Sachs derivatives group notified it's hedge fund clients that it would no longer step in for Bear Stearns on derivative deals. Hedge Funds were astonished to say the least. This led to an enormous amount of clients yanking their money out, not to mention the short players crushing the stock price. Goldman Sachs did nothing illegal by stating this; but it is definitely a great big, huge, enormous example of the need for higher capital requirements.

From the recent Federal Reserve Senate Banking Committee testimony, the general consensus was one of looking into the abyss and pulling the financial system out. The Fed believed that inaction would have caused "chaotic unwinding" of investments throughout the U.S. economy. Ben Bernanke stated that, *"The adverse effects would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability."*

The Right and Wrong Ways to Slay the Beast

My son Stephen likes to categorize animals into two separate camps. Good animals and bad. For example: On a recent trip to Busch Gardens he inquired into whether the enormous vulture they had on display was a *"bad bird."* I have tried to explain to him that animals are neither good nor bad and all serve a purpose, but because of the existence of sharks, I don't think I have fully convinced him of the whole food chain concept. I try to elucidate him to the fact that vultures, hyenas and sharks while all being dangerous, all serve a purpose and are all necessary within nature. The same is also true when it comes to investment vultures.

As of late, there have been countless articles and stories penned describing vulture investors, all of which are waiting and biding their time to pounce on distressed assets and take advantage of some poor investor. A vulture is not exactly a term of endearment, however, in this case it should be. I don't call them vultures or sharks, I call them smart. Benjamin Graham, who was Warren Buffet's teacher described assets as having centers of gravity or an intrinsic value. At times those assets will trade above that value and at other times below. In other words... buy low, sell high. You never here CNBC or the press call Warren Buffet a shark or a vulture. But what do you think he is doing right now? Buffet is the ultimate predator. He is on the top of the food chain because he is capable of hiding behind his folksy Oracle of Omaha demeanor. He actually tried to sell mutual fund bond insurers backup insurance for their bond pools. Question: How often do you see AAA municipals default? Answer: Very seldom! Did you also know that Warren the Oracle is a funeral crasher? That's right! The reason Warren Buffet is so fond of the death tax in the United States is it allows him to buy up family run businesses on the cheap when they fail to plan their estate accordingly. Warren the shark knows that the estate tax needs to be paid in full within 12 months. Therefore, he can swoop in and grab bottom basement, estate sale, everything must go prices.

The subprime crisis has become a hot topic within the Washington beltway with the usual stampede to the podium, with calls for cure-alls, band-aides, and finger pointing coming from all directions. Two of the candidates state that they can fix the problem, as long as you vote for

them. They are promising the sun, the moon and the stars to subprime borrowers with economically vapid ideas such as...

Freezing mortgage rates. That seems really fair and constitutional. Force lenders to charge an interest rate determined not by risk factor and current market conditions but by a politician that has never run a business in their lives.

Allowing Bankruptcy Court Judges to Reorganize Loans. Another whopper! What do you think is going to happen to the availability and cost of mortgages once lenders are subjugated to bankruptcy judges that could alter the terms, conditions and principal of the loan? Good luck getting a mortgage!

Tax-Payer Bailout. Advocates for this Marxist cash grab feel that many Americans are being too responsible with their finances with conduct such as, buying a home that they can afford, and actually paying their bills on time. To reward those Americans for being responsible these hammer and sickle wielding comrades want them to start paying back delinquent individuals mortgages. Congratulations tax-payers, you have another mortgage!

Quite frankly, I am the idiot. I should have gone out and bought the 12,000 sq ft home, with no money down and the interest only ARM. So what if I couldn't afford the payments, who needs to make payments when the government is going to raise the money and take care of it for me. The late William F. Buckley Jr. once stated, *"Idealism is fine, but as it approaches reality, the costs become prohibitive."*

I am also quite weary of idiot politicians using inane historical references to further their regulatory agenda. I have heard two specific presidential hopefuls and their comrades compare the current leadership to Herbert Hoover. Conventional wisdom holds that Herbert Hoover did nothing while the Great Depression took hold. Conventional Wisdom is wrong. Herbert Hoover actually helped turn a recession into a depression. In 1930 Hoover signed into law the Smoot-Hawley Tariff Act which set off protectionist retaliation that undid the globalization of the preceding decades. In 1932, while the country was in a recession, Hoover repealed the Calvin Coolidge-Andrew Melon tax cuts, thus raising the top marginal income tax-rate to 63% from 25%. No longer a recession...we then had a depression. Questions: What political candidates/party wants to eliminate and/or cut back on trade? Which ones want to raise your taxes?

Hercules had quite a battle on his hands facing a beast like the Hydra. He succeeded by covering his mouth and nose with a cloth to protect himself from the poisonous fumes and fired flaming arrows into its lair. He then attacked it wielding a harvesting sickle. Realising that he could not defeat the Hydra in this way, because multiple heads would grow back, Hercules called for some help, his nephew Iolaus. His nephew then came upon the great idea of using a burning firebrand to scorch the neck stumps after Hercules decapitated the beast.

We do not need Hercules to bail us out of our subprime/real estate/economic downturn. We need Adam Smith. Simple market discipline, lower housing prices and bankruptcies are cleansing a system. Rather than try to keep people in homes they really cannot afford, let these homes hit the market and be scooped up at discount prices. Allow a bottom to be reached, and the buyers will come back to the market. Staving off the inevitable prolongs the pain. The market will take care of itself. Will their be pain? Of course! Free-market capitalism involves risk. Sometimes risk pays-off; sometimes it doesn't. Some people bought pre-constuction condos, flipped them and made money. Others did not. Some investors made money in Enron. Others did not. We can not legislate losses out of the system. If we do that we might as well turn the keys over to Raul Castro. I am glad that in this financial calamity the big financial firms took it on the chin. The dotcom boom taught them nothing with some lousy fines and everyone skating free. This current situation could lead to some positive changes. I feel that the entire financial supermarket concept born out of the Glass-Steagall repeal was never in the investors best interests. We have

written and reported on the abuses and conflicts over the years. Not to mention the never discussed upon fact that banks agreed to the Community Reinvestment Act as a compromise to repeal Glass-Steagall. That act forced banks to ease lending constraints to borrowers who would not traditionally qualify. Government dictating loan terms to banks was a major factor in today's calamity.

Herbert Hoover's Treasury secretary, Andrew Mellon, stated, *"Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate...It will purge the rottenness out of the system."* Those words, though honest, don't resonate well during an election year. My hope is that the most ill-fated attempts to *"fix"* the economic crisis that will ooze out of that majestic white building in Washington D.C., called the capital (I like to call it the *"Church of Unintended Consequences"),* will fall flat. Recall some of the more recent band-aides. Sarbanes-Oxley, which in my opinion is a politician's dream and small-business nightmare. Another is the 1993 legislation eliminating the deductability of CEO salaries over $1 million. This led to the stock option abuse, and the all too often practice of CEO's managing the stock price rather than the company.

Slowly, but surely, the system is cleaning itself out. Lessons are being learned Adam Smith style. If the markets are allowed to work we may end up with a better system, maybe a safer system. Hopefully many of the fly-by-night hedge funds will be no-longer. Perhaps more individual investors will come to understand the market's limitations and not fall prey to the get-rich-quick cons**.** These things are all possible as long as the government stays out of the way.

Caroline Baum of *Bloomberg* appealed for one government official to unveil the John Galt plan to save the economy. Galt, was the hero of Ayn Rand's, *Atlas Shrugged*. He stops the world by going on strike. He and the *"men of the mind"* literally withdraw from the world after watching their wealth confiscated by the looters (government). Spoiler alert!!! Toward the end of the book, the economy is in shambles. Desperate, the government kidnaps Galt and prods him to *"tell us what to do."* Galt tells them *"to get out of the way."*

We want the government out of the way when the economy is roaring and we want them to step in when it isn't. Some banks need to fail. Some people need to have their home foreclosed upon and some hedge funds need to go belly up.

The sooner the better!

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