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Investment Paper is Liquid....Until it Isn't The Story Behind the Bear Stearns Case

Loss of liquidity = unknowable value

Nearly everyone knows that stocks listed on major exchanges share one major reason for their listing: the “electronic paper” securities behind those names in the listings rest on a universal belief that investors who own those securities can readily sell them on any market day. And that’s the way it really works....until it doesn’t. There is no guarantee that an otherwise actively-traded securities market might not suddenly just seize-up. The low water mark in modern history was in 1987, when, on October 19th, un-imaginable trading volume whacked the Dow Jones down by 22.6%...far worse than 1929, when the Great Depression era was launched with a 13%, one-day stock market plunge. On October 20, 1987, the New York Stock Exchange opened on the morning-after at 9:30, as usual, but a panic ensued: many of the exchange’s biggest names simply did not begin trading. Fed Rescue: Around 10:30 that morning, then-new Federal Reserve Board Chairman Alan Greenspan quickly intervened, promising emergency lending to capital-drained stock exchange floor traders; the market suddenly became “liquid”. Sound familiar?

The most recent event was the dismal story of venerable Bear Stearns. Until recently, Bear was one of Wall Street’s top five trading houses; its publicly-traded shares went for more than \$170 in early 2007. By mid-summer, the illiquidity-monster struck two Bear-operated hedge funds that had invested huge percentages of assets in sub-prime, home-mortgage-backed securities which had fallen from darling-to-dog status, as the nation’s housing market quickly soured. The cancer spread to Bear’s balance sheet. By early March 2008, Bear shares had been beaten down to \$60 and then, in a single day (Friday, March 14th), collapsed to \$30, as the market reflected Street rumors that Bear’s capital and customer base had disappeared. Finally, there came an over-the-weekend deal engineered by the Fed: a transaction which would have JPMorgan Chase

acquire all of Bear at a garbage-level \$2 per share....a price that, as many observed, was so puny it added up to less than the value of Bear’s nearly-new Manhattan headquarters skyscraper. This stealthy, Bear/JPMorgan ides-of-March “deal” was instantly and widely viewed as a bailout....a handy pejorative term, adored by the media for its predictable power to stir controversy until it boils over to a national resentment that not only sells cable TV time and newspaper space, but also spurs Congress-people to make speeches and propose legislation heralded to be an election-year fix. So, was it a bailout? Perhaps, but when Bear’s shareholders (over 30% of whom were employees) awoke that Monday morning to find they owned a \$2 stock, they justifiably felt mugged rather than bailed.

What happened?

Like many Wall Street traders including Merrill Lynch, UBS, Citigroup and others, Bear Stearns wound up holding investments in a multi-billion-dollar boatload of securities backed mostly by home mortgage loans that were, at best, highly dependent upon a continued surge in residential property values which, at worst, had easily qualified for full fledged bubble-status by mid-2006. (Please see our January 2006 White Paper.) Those particular mortgage loans which politely came to be called “sub-prime” had an insidious, corrosive characteristic. They were mostly created by homeowners who had: (a) little, if anything, invested in a down payment and (b) marginal ability to repay, having provided no proof of their income (“no-doc” loans). There were similar mortgages (“Alt-A”, “low-doc” loans) deemed to be crème that were packaged into securities and awarded AAA credit ratings. The ultimate killer-feature for a majority of sub-prime borrowers was the adjustable interest rate. Adjustable-rate loans were seldom explained by mortgage brokers, but were instead aggressively sold to home-buyers. The loan brokers, of course, received their full commissions on the day of loan closing...and that was that...for them.

The root of Bear's problem was that a significant portion of its working capital was tied up in mortgage-backed securities that had rapidly turned illiquid and could no longer be used for collateral.....the root, yes, but the hammer that nailed Bear's coffin shut was the collapse of other Wall Street firms' willingness to do business with Bear. This sudden crisis of confidence was fed by rampant Wall Street rumors that the firm was rapidly running out of capital and had already run dry of resources to borrow more money, the result of which would be Bear's inability to settle its trades (i.e., deliver securities or cash). Trade settlements, after all, are a vast trust-relationship network between broker/dealers.

But, why did it happen?

Now that we understand what Bear and its worldwide, sophisticated investment banking brethren *should* have known, it is more important than simple curiosity that we find out why they bet the proverbial farm on such shaky paper. The answer is two-fold:

- (1) Greed: Mortgage-backed securities, juiced with sub-prime loans were designed to pay a handsome interest spread above the benchmark LIBOR floating interest rate; interest rates on this mortgage-backed paper significantly topped what could be earned on investments in traditional corporate bonds;
- (2) Risk avoidance: Most of the sub-prime home-buyer/borrowers whose loans support the mortgage-backed securities were signed up to pay an adjustable interest rate. So, Bear Stearns and other giant investors in these securities *thought* they were avoiding the bugaboo of bond investing....rising market interest rates that depress the value of fixed rate bonds. Indeed, rising interest rates were a highly likely scenario because, by 2003 when sub-prime mortgage-backed securities began to be popular, the Fed had driven US short term rates down to an incredible, but temporary 1%. (As things turned out, that Fed string of rate-cuts provided the manure to fertilize an explosion of 3% adjustable "teaser rate" mortgages which, by 2007, were literally forcing over-leveraged, middle class, marginal borrowers out of their de-valuing homes).

And how did it happen?

"Investment grade" credit ratings were issued on most tranches (segments) of the sub-prime mortgage-backed securities by the four recognized credit rating companies. Armed with those solid credit ratings and high interest yields, the sub-prime securities sales force found

that Wall Street institutional investors like Bear Stearns gobbled up all they could produce. In fact, The Street's demand outstripped the supply which (predictably) led to more supply, supported by progressively shakier home buyers and condo "flippers", borrowing 100% (or more) of their purchase price.

Given the sub-prime paper supporting these securities, why were their credit ratings so high? At best, it was the ratings-issuers' greed; at worst, it was those credit experts' failure to perform adequate analysis. Here's a clue: The credit rating companies found that their customers would pay triple the amount of fees for rating mortgage-backed securities, compared to fees for rating conventional bond issues. (In the first quarter of 2007, Moody's, the only stand-alone, publicly traded ratings company, saw its revenues from ratings issued on "structured finance" products rise to 46% of its entire revenue from ratings; another fact, the price of Moody's stock more than tripled between early 2003 and mid-2007.) The result: *tens of billions of dollars worth* of these investment-grade-rated securities became owned, worldwide, by the in-house investment portfolios of sophisticated investment banks and even some commercial banks. So, how did we get from there to a "crisis"? In normal times, these banking firms would use the mortgage-backed securities as collateral for borrowing money with which to do business. For them, "doing business" is the everyday financing of their clients' big deals: mergers, acquisitions, hedge fund trading, etc. In brief, the scenario was big financing institutions borrowing from other big financing institutions, using mortgage-backed securities as collateral.

The Bear facts

In early 2007, shares of Bear Stearns' stock were trading at more than \$170; by March 2007, shares were only \$150. Then, suddenly last summer, a crack developed in the debt-dyke. Two hedge funds managed by Bear Stearns for outside investors ran aground on their substantial mortgage-backed securities holdings; the underlying home mortgage borrowers were defaulting at a rate higher than had been built into the models for valuing the paper. The two hedge funds immediately faced a liquidity crisis from investors wanting to withdraw. Although Bear Stearns did not "own" the hedge funds, it did place the funds' sub-prime securities investments and its good name was on the line. (By August 2007, Bear shares were trading around \$120.)

This mini-crisis for one Wall Street firm turned out to be the first domino in a very long daisy chain of financial industry trust relationships. In the end, those tumbling dominos would not only bring Bear to its knees, but also decapitate it. The looming doom for Bear apparently blindsided the company's insiders; an entity called the *Bear Stearns Companies 2008 Trust* bought 27.3 million shares of Bear's stock (*well over \$2 billion worth*), on or about Valentine's day 2008, when it was trading around \$80. But exactly one month later, Bear's share price fell to what appeared to be a thoroughly trashed "bottom" value of \$30. Finally, without so much as fleeting chance for the market to whimper, Bear shares opened the next market morning at the eye-rubbing price of \$2, following a weekend deal brokered by the Fed with JPMorgan Chase. This share price meant the total value for the company was little more than \$200 million which, as many observed, wouldn't be nearly enough money to purchase Bear's shiny new home office building in Manhattan.

De-regulated markets: a good thing?

In the 1933 depth of the Great Depression, Congress enacted several regulatory laws designed to prevent things that had gone awry in the banking, finance and securities industry which were deemed to have caused, or contributed to the US stock market's 1929 crash. One of those laws was the *Glass-Steagall Act*; it prohibited commercial banks from collaborating with full-service brokerage firms, or participating in investment banking (securities issuance underwriting) activities. So, for nearly 70 years, securities and banking were legally separated. But, one month before the end of the 20th Century, Congress succumbed to years of pressure and repealed most of Glass-Steagall. Thus, only 8 years ago, the likes of Citigroup, Merrill Lynch and Bear Stearns began to serve as look-alike, one-stop shops for every financial service and product. Meanwhile, the Federal Reserve Board's regulatory powers continued to be limited to the depository commercial banks, while the Securities and Exchange Commission continued its very separate domain over investment banks. By the end of 2006, we understand, only about 17% of the US credit market's activities fell under the jurisdiction of the Fed.

The Fed unchained

The Fed's Bear Stearns maneuver marks the first use of newly devised and now-being-justified tools in the Fed's economic engineering bag. Without legislative ado, the Fed has just made

clear that it intends to include investment banks in its mission statement, which includes fix-up schemes for instability in the US/global financial system.... a network which is now so over-stuffed with derivative betting and counter-betting by hedge fund traders that the Fed had (has?) clearly lost any meaningful control. Via the Bear Deal, the Fed entered center-stage, asserting itself as the ultimate controller of all things financial (in situations when it really matters). In so doing, it made clear to the world that it stands ready as the Ultimate Insurer against extreme, low probability situations involving strangulation of normally liquid financial markets. But, how can the Fed pull off such Houdinian acts, since it has no taxing powers? Very simply, in its role as the US Central Bank, it has the unique power to literally order the printing of more dollars.....billions of them, if needed, which can be quickly injected, like some life-saving plasma, into a financial market that has seized-up. [Note: such injections are inevitably inflationary, because they increase the supply of money, unsupported by commercial activity.]

The future

The result of The Great 2008 Fed Intervention should be that the financial markets quickly recover their functionality, permitting the Fed to quietly return to the sidelines. In the Bear Stearns deal, the Fed agreed to take the \$30 billion (face value) of Bear's investment in sub-prime mortgage-backed securities, as collateral for issuing a \$29 billion line of credit to JPMorgan Chase which was apparently the only firm with any degree of interest in acquiring poor, burnt-out Bear. Nobody, literally nobody knows the market value of the securities which the Fed took as collateral, because nobody in the market is currently willing to buy them. It of course remains to be seen whether taxpayers will wind up with a loss. At least the Fed has no urgency to sell; it can roost on the securities as long as necessary, until market trading in such paper is again more liquid. Even if this paper turns out *never* to be liquid, it would be harsh to assume that the Fed's \$30 billion loan to JPMorgan Chase will likewise go bad.

Killer lessons [probably not] learned

Three, interrelated investing sins (and examples):

1. ***The sin of assumed liquidity*** (\$multi-billion markets will never cease trading)
2. ***The sin of extrapolation*** (housing prices have always gone up, therefore....)
3. ***The sin of "if, then" correlation*** (if ARM rates rise, then simply sell....and keep the profit)