The Credit Mess and Where We Are.

By Michael Cohn

Let's try and distill what is going on with the financial markets. It all started with the irrational belief that asset prices would continue to rise indefinitely. Or, for those that knew better, that the whole liquidity and asset appreciation party would not come to a screeching halt.

The first shoe to drop, as everyone knows, was the real estate market. Each and every time someone was lent money to buy an ever increasing supply of expensive real estate, the loan, no matter what the qualification of the borrower, was sliced up and inserted into securities that institutional investors across the board had in their portfolios. The money that went to buy these mortgage securities came from a whole rainbow of investors, sovereign funds, pension funds, insurance companies, 401k plans, banks, brokerage firms, hedge funds, and high net worth individuals. Since these individuals and entities control 95% of the wealth in the developed world, when these securities were suddenly viewed as potentially toxic, everyone ran for the door at the same time.

Normally, if one or two securities in a portfolio become worthless or go down appreciably in price, it would be no big deal. That is why diversification works. The issue that gave these "institutions" heart attacks was leverage. Everybody that borrows money to buy an asset is using leverage. Long ago (or so it seems) when you got a mortgage for a house, you put down 20% and the bank lent you the rest. That is 5 to 1 leverage. If a bank lent you money with 10% down that is 10 to 1 leverage. A hedge fund could borrow money from banks and brokers with only 5% down and in many cases only 2% down. When the prices of the asset(s) you were lent money to buy goes up, leverage is wonderful. When the value of your portfolio goes down by 10%, and you have 20 to 1 leverage, you need to sell a lot of the securities in your portfolio and raise more equity or you are technically insolvent. In order to stay in business you will sell what you can (your good investments) because the assets that are creating the problem (in this case) can't be sold because no one will buy them.

Banks operate their businesses on 33 to 1 leverage. Brokerage firms also use 33 to 1 leverage. This can be misleading because of the proliferation of so called "off balance sheet vehicles' which often use even higher leverage. For every dollar they have on hand they lend 30 dollars or own 30 dollars worth of securities. So far these entities have written-down over $100 billion on mortgage securities, so if you do the math that is about $3 trillion that is now not available for lending or to purchase securities.

Leverage is now viewed by investors as a bad word. When hedge funds, insurance companies, banks and brokerage firms all de-leverage at the same time, it's a wonder that this market has held out as well as it has. If there is a sudden panic and investors run for the exits, so to speak, the whole financial market melts down. Stocks, municipal bonds, and high quality corporate debt have suffered because they are good assets and they can be sold quickly and for relatively reasonable prices. For those who have investment cash right now these high quality assets are great bargains in the absence of a total financial meltdown.

Interest Rate	**388 T**
Credit Default	**51 T**
Foreign Exchange	58 T
Equity	11 T
Commodity	8 T
Totals	**516 T**
Trillions of U.S. dollars	Source: I.S.D.A.

In reality this is just the tip of the iceberg faced by these institutions. Derivatives are the 800 pound gorilla in the room. The derivatives market faces both massive counter-party risk, and the ominous systemic risk. There were about $516 trillion worth of derivative contracts outstanding at the end of 2007. Over 90 percent of these contracts are traded on the unregulated over-the-counter (OTC) market. To put this in perspective, the gross domestic product for the world was $50 trillion in 2007. According to Merrill Lynch the total value of all bonds outstanding at the end of 2007 was $72 trillion. Looking at the table on the right you see that there is about $440 trillion worth of bond (Interest Rate + Credit Default) derivatives outstanding. There are more that 6 times the amount of derivatives on bonds than there are bonds outstanding. In comparison, the global market value of all equities is around $50 trillion and the equity derivatives market value is only 11 trillion, a 1 to 5 ratio.

Derivatives were created originally to hedge the investment risk of holding an asset. What they have become is a way for the hedge funds to speculate, creating a casino mentality. The real problem is that these are unregulated, non-

standard contracts. Hedge funds account for almost 60% of the trading in credit derivatives. A bank that is legitimately hedging some bonds they have on their books might (or most likely) have bought default or interest rate insurance from a hedge fund. If the hedge fund makes some bad bets and goes bust, there is no one to pay off the derivative contract anymore. The market for these contracts has seized up, and the bank will not only lose money on the bond but there is no one to pay off on the hedge. For example, do you see anyone wanting to assume Ambac's mortgage default exposure? Certainly not. It is as if you owned homeowners insurance from an insurance company that has no ability to pay when your house is destroyed. This is what is meant by counter-party risk.

If a bond goes into default, in order to for credit default insurance (CDS) to pay off, you have to deliver the bonds to the insurer. This is just like if you wreck your car, you have to deliver the car to the insurance company in order for them to pay on the claim, and so they can salvage some value by selling off the good parts. Just say Bear Stearns goes bankrupt (?), more than likely there is six times more credit default insurance on Bear Stearns than there are bonds. If they go bust tomorrow there will be a scramble to buy the bonds, because for every Bear Stearns bond outstanding there will be six buyers even though they might be worthless. A similar analogy would be if there were six different people who bought collision insurance on your car. When you wrecked your car there would be six people scrambling to deliver your car to the insurance company so they could collect the insurance. That exact scenario happened to Delphi Automotive. Essentially worthless bonds were trading at 75 cents on the dollar because most of the owners of Delphi default insurance didn't own the bonds. They were essentially just betting on the company's eventual demise. When the (credit) event happened sooner than they thought, suddenly there were more buyers of the bonds than bonds outstanding. This market has lost its original purpose as a legitimate risk management tool. With six times as many contracts outstanding as there is product, the counter-party risk is enormous. If everyone at once tries to liquidate these contracts they become worthless and the whole derivatives market becomes dysfunctional and worthless as a legitimate tool to hedge risk. As a money manager you just pray that a $400 plus trillion market doesn't go into a panic. This will set off a chain reaction that will greatly affect all other financial markets. This is what is meant by systemic risk.

Bad luck seems to come in threes. The first shoe to drop was the real estate market. The second shoe was the municipal bond insurers. Shoe number three is Bear Stearns. If we are lucky most of the bad news is out.

There is a lesson to be learned here. Despite the rhetoric, the banks and most large brokerage firms really are not very good at risk management. Certainly, there are a lot of the smartest and most highly qualified investment professionals within them. The problem is periodically greed overtakes good sense. One had to only open their eyes to see this coming back in early 2007. The only question was when.

Risk management is an art. It is very simple to take no risk, and it is equally simple to take a huge amount of risk. The art is in the balancing act between the two extremes. Today there are some fantastic investment opportunities. Municipal Bonds are trading at relative valuations that have not been seen in decades. Equity options present a tremendous opportunity to generate substantial income to owners of stock by way of a covered call writing strategy. Commodity investments are only in the first leg of a tremendous long-term bull market. If your investment professional has not suggested these investments and strategies to you, you probably need to look elsewhere for investment advice. There is a leap of faith one might want to take here. It is that, in the name of self preservation, the same people that got us into this mess will manage get us out of it before it all hits the fan. If you understand that risk can be your very good friend if managed correctly, but you would like to let someone else lose sleep over it for you, please give us a call.

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