

November 5, 2007

What Now for the Credit Markets?

For the past several years, we have been warning about credit risk. There are several ‘trading commandments’ that I live by (some of which are from my friend and partner, Todd Harrison of Minyanville.com). At dinner this past weekend with my son and one of his friends in a quaint pub in Chapel Hill, North Carolina, my son’s friend asked about the commandments. The great part about young adults about to make their way into the real world is their constant thirst for knowledge from academia and from those of us that have learned our trade from the daily battles of trading and money management.

There are lots of clichés that we can point to when navigating our way through the shark infested waters of Wall Street. I will list a few that I live by every day while managing capital for myself and others.

- Buy low, sell high.
- Buy rumor, sell news.
- Buy from the fearful, sell to the greedy.
- Buy when you can, not when you have to.
- The reaction to news is more important than the news itself.
- Cut your losses short and let your profits run.
- The crowd is nearly always wrong at extremes.
- The key to making money is not losing money.
- It’s not about being right, it is about making money.
- **If you are not being paid to take risk, do not take risk, particularly CREDIT RISK.**

Note that I put the last item in bold as I find it is the most important of all trading commandments. Risk management, and lack of drawdown is perhaps the most important and most often overlooked discipline in the investing world. At dinner my son’s friend began writing these tenets down as he had never heard them in a classroom environment, and likely won’t. The academic parts of accounting and economics are important to be sure, but managing money in real-time is an animal all to itself.

When I said that I live by the concept of ‘buy from the fearful and sell to the greedy’, his eyes lit up. I quickly summarized the concept the following way: if the four of us at the table made up the entire investing populace and we all had the same opinion about a particular security or asset class, there would be ‘no one left to take the other side of the trade’. If we were all fully invested in a particular security or asset class and good news came out, our first inclination would be to sell the security as we had bought it in anticipation of the news. But of course there is no one left to buy, and the security would likely fall in price. Conversely, if the four of us were all asked about a particular security and we all said we hated it, it would likely be because we did not own the security. Imagine asking a group of investors that owned zero shares of Microsoft what they thought of Microsoft—they likely didn’t own any or had even sold it short and were hence a source of buying power. This is why the reaction to the news is more important than the news itself. It gives us a clear indication of how the crowd is positioned. If a security falls on good news, the good news is said to be ‘discounted’. On the other hand, if a stock rises on bad news, the bad news is said to be ‘discounted’. These moves can be temporary, but often signal a change of trend. Sharing these experiences with others, particularly young adults is a gratifying part of my job, and one that I enjoy the most after 27 years or so in the securities industry. I try to help others not repeat the same mistakes that I have made.

When my partner Rob and I talk with clients, we are often asked, “What is your primary investment approach?” While Rob and I come from different backgrounds, we both agree on this concept-THE FIRST KEY TO WINNING IS NOT LOSING.

There are several reasons for this: emotional - (losing money burns through what I like to call ‘emotional capital’), mathematic - (if you lose one third of capital, you need to make fifty percent to get back to even) and lastly, simple risk management - (if you seldom lose, the upside takes care of itself). So when we are asked, “What are the potential returns in the Harbor Pilot Fund?”, we have targets, but like to focus on the lack of loss first. We examine how our portfolio would behave if we did everything wrong. To do this, you have to shrink your ego immensely (something that is hard for all of us), but it does keep the potential for loss lower than much of our competition. As a result, we will likely never have the highest return on the block, perhaps except when everyone else is losing. I think it is dangerous to plan for everything to go right, because if you do, it is difficult to calculate your potential losses.

This leads me to my current view on the credit markets, how we are currently positioned, and my view on the next couple of years.

Way back in November 2006, I was interviewed by The Wall Street Journal Online ([Click Here for WSJ Article](#)) alongside another investment manager, who managed multitudes more money than I did. I steadfastly said in the interview that by the Autumn of 2007, the Fed would be forced into an emergency interest rate cut as there may be a financial ‘accident’ or two waiting for us. Later, in January 2007, I was interviewed by Bloomberg News ([Click Here for Bloomberg Article](#)). Coincidentally, this is the article that my partner Rob read that eventually brought us together as partners. In this article I suggested that there was a ‘disaster scenario’ building for stocks. I was labeled a bear, which frankly I am not. I am admittedly cautious with capital that I manage, but am neither a bull nor bear, just a market participant that must make judgments daily if we are to be properly compensated for the risk we are taking, particularly CREDIT RISK, (as I wrote in the bullet points above). Trust me, this is not a back slapping exercise (the investment gods have a way of knowing when we are feeling cocky and quickly lob a lightning bolt in our direction to remind us to remain humble at all times), but just to say that there is a little bit of precedent here before I assess where we are in the credit cycle and how far it can run from here. So here goes.

One recent morning, I was driving to the office and listening to Bloomberg News. A British economist was being interviewed and was asked what ‘inning’ he thought we were in in the credit market bust. His answer was captivating. He said, “I think they are still singing the national anthem”, which of course is done BEFORE a game starts. I think his comments, while on the mark, may have been a bit draconian, but frankly, I agree at least in principle. We have indeed begun the unfortunate and uncomfortable unwinding of the debt bubble I have been harping on for years, and I don’t expect it to be fun. The way these cycles occur is that the best loans are made first and the lowest quality loans are made at the end of a borrowing cycle. We are, of course, just now, seeing the unwinding begin. The lowest quality loans (sub-prime mortgage loans) are now beginning to default in greater and greater rates and are impacting all of the leveraged investment vehicles packaged courtesy of Wall Street alchemists and bought by greedy investors armed with cheap capital (thank you Chairman Greenspan).

Just how bad is this sector unwinding? 170 subprime lenders have shut their doors just this year according to www.ml-implode.com and I am sure there are more on the way. How quickly are the investments going sour? Just the other day, I saw a \$1 billion ‘super senior AAA rated CDO (collateralized debt obligation)’ downgraded by the ratings agency Fitch to Baa2 with just an air pocket of ratings changes in between. Frankly, I have never seen this before. Usually, you see an orderly downgrading from AAA to AA to A, etc. But from

AAA to Baa2? That was a first for me but surely not the last, as Fitch suggested 500 other securities were about to face a similar fate.

Will there be more? Sadly, I happen to think so, and it explains why we remain invested in only the highest quality (GNMA, FNMA, etc) with a smattering of high quality utilities and industrials. We are even avoiding municipal bonds as the two largest municipal insurers, MBIA and AMBAC are on shaky ground, so investors had better be prepared to have their municipal security stand on its own merits. We are also avoiding municipals because I have no way to quantify the impact on real estate tax reductions that are sure to take place as home prices fall, taxes go unpaid and delinquencies skyrocket.

This is sobering, but I am not paid to be ‘happy go lucky’—rather I am paid to constantly quantify if we are adequately being compensated for credit risk and the answer remains NO! Period. Not even close. This is how we avoided draw downs in portfolios for so long and will wait until spreads normalize before considering credit risk. Just how abnormal is the pricing of credit risk?

Consider this. As I have written of late, there has been a bifurcation of credit quality. Sub-prime loans and their derivatives are getting re-priced while the very high grade part of the market is doing just fine, thank you very much. One glaring exception, and one we have been taking full advantage of in real-time is the fact that ‘the baby is being thrown out with the bath water’ as it relates to mortgage backed securities.

Imagine that you are a leveraged hedge fund or leveraged speculator with positions in illiquid CDO’s and subprime ABX tranches and also had positions in GNMA/FNMA paper. You are levered to the hilt, because when you bought these bonds, spreads were tight and borrowing costs were low. Today, however, your prime broker or margin clerk walks in the room (or sends you an e-mail) saying “MARGIN CALL!!!!”. You have two choices; you can try to sell what is causing the problem in the first place, which incidentally, has no liquidity, or you sell what you can, which is the most liquid high-grade paper. You are now in the position of ‘sell what you can, not what you have to’. Note, this is the opposite of one of the bullet points above which states, ‘buy when you can, not when you have to’.

Ahhh, this is the power of financial leverage at its worst. Those that are un-leveraged, even with an ‘off sided’ position, can sit it out. Those on margin or levered, whether they like it or not, are at the mercy of the margin clerks. Are there profits amongst the wreckage? I am sure that there are, and to be honest, we are in the early innings of considering how to play the ‘distressed mortgage’ market, but that is for a later date and to be deployed by someone other than me as this is not my area of expertise. The result of all of this is that high grade mortgage backed securities remain cheap in our view, we continue to think prepayment speeds will remain low as housing continues to stall and are drastically over weight this area relative to corporate bonds. Speaking of corporate bonds, I still cannot believe my eyes when I see IBM paper being offered cheaper than the JP Morgan Emerging Market Sovereign Bond Index. I realize that emerging markets are becoming developing markets, but they are still not of higher credit quality than IBM (at least in my humble opinion).

In summary, when I am asked what inning we are in as regards the credit re-pricing, I will offer this. We are not in the first, nor are we in the last. How do we know this? **As stated above, we aren’t being adequately compensated to take credit risk, so do not take credit risk.** Secondly, I read an article regarding assets that are priced on the books of investment banks. These loans are broken down into ‘types’.

1. *Type I—those bonds that are being ‘marked to market’ or where you could actually sell them according to the last price.*

2. *Type II—those bonds that are being ‘marked to model’ or where, if, and this is a BIG if, you could sell your bonds so long as your analytical model held up.*
3. *Type III—those bonds that are not liquid/and or high quality enough to be qualified as Type I or Type II and are ‘marked to management’—or prices if the model worked and if the market was liquid enough you could maybe see your bonds. This is basically management’s BEST GUESS.*
4. *Type IV—those bonds that Warren Buffett likes to call ‘mark to myth’. These bonds are past the problems of Type III but have to be marked somewhere. And we all know that the Oracle of Omaha is right, these prices are truly mythical.*

Now for the big problem. In the article I read, the granddaddy of investment banks, none other than Goldman Sachs, has TWICE AS MANY TYPE III LOANS AS THEY DO CAPITAL. Other investment banks are in the same boat, not to mention hundreds of hedge funds and others that own CDO’s and the like. The reason these bonds don’t often trade is that if you were in their shoes, would you rather own Type III or Type I? For them, knowing if they HAD to sell at ‘mark to market prices’, their capital would disappear. Just ask Merrill, Citigroup or the legions of others that are just beginning to own up to all of the garbage on the balance sheets. Are there enough distressed buyers and folks like cash rich Warren Buffett here to bail them all out? Truthfully, I do not know, but until I do, I will continue to tread cautiously with the capital we manage. To be sure, there will be opportunity along the way, and when the coast is clear, I expect to reverse course, and prudently take risk. Until then, I will just sit back and watch the ‘global margin call’.

Bennet Sedacca
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(Positions in GNMA/FNMA/GS)

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