

December 10, 2007 The 4 B's: Buybacks, Bifurcation, Bailouts and Bankruptcies

I write this piece on the way home from the annual Minyanville Festivus in New York, a gathering of some of the country's greatest investment minds. I am honored to be part of the Minyanville community and to contribute whatever knowledge I have gained during my career. At Festivus the hot topic was the sub-prime bailout, which was crafted jointly by Treasury Secretary Paulsen and President Bush last week. It is this very topic which inspired me to write this piece. Many people I have come across recently are questioning the sub-prime bailout. As a proud American, I am always there to pay taxes that take care of basic social programs. But I wonder if we are crossing the line of democracy into the land of socialism. This is a tough subject to address, but running from the truth isn't right either.

#1 : Buybacks

When I started in the securities industry way back in 1981, there were a few important investing "rules" we were taught. One such rule was that the stock market was "cheap" when dividend yields were as high as 6% for the S & P 500 and considered "expensive" when yields were as low as 3%. In fact, if you look at a chart from 1900 to 1995, this relationship actually held true. Then, suddenly, in 1995, the range of 3 to 6% dividend yields suddenly broke down. We have not seen dividend yields anywhere close to 3% since 1995.

At the peak of the stock market bubble in March 2000, dividend yields fell below 1%. I remember this vividly, because as a value oriented hedge fund manager, 0.95% got my attention. We must keep in mind that the S & P 500 is a capitalization weighted index and at the peak in 2000, the largest market cap stocks were Microsoft, Cisco, etc—those stocks with dividend yields of 0. One would conclude then, that, since the tech bubble broke apart and tech stocks proceeded to fall by 80 percent into the October 2002 low that the dividend yield would climb steadily as these tech titans had less impact on the index. But no! Alas, they have stayed stubbornly between 1% and 2% since 1995 (please note, however, that the Dow Jones Industrial Average has recently climbed all the way to 2.25%).

For those new to the game of investing, you should know that nearly half of all stock market returns since 1900 have come from dividends. Yes, dividends. So, the way I see to properly analyze the balance between stocks versus bonds is to look at what we can earn in bonds. Lately, we have added Freddie Mac and Fannie Mae Trust preferred shares in the 7 to 8% annualized dividend range. Because their dividends qualify for the 'dividends received deduction', the tax equivalent yield is nearly 11.5%. If we are paid a paltry 1.75% to own stocks, stocks must therefore gain almost 10% per year just to keep up with the Trust Preferred Stocks.

Investors in stocks normally demand to be paid a 'risk premium' or some spread over lower risk securities. Please don't misunderstand me—Freddie Mac and Fannie Mae preferred shares aren't without risk, but I believe they have less risk than the S & P 500. Given this relationship and a risk premium of around 3%, stocks need to earn 14% including dividends. This means that 12.25% would have to come from capital appreciation. This is double the rate that stocks have appreciated over the past century. And this would have to happen every year.

Since I doubt a 12+% annual appreciation rate can be sustained, I can only conclude that the great debt induced buyback experiment has backfired, and explains our cautious view (even more cautious than usual) towards equities based on simple risk/reward analysis.

The excuse for low yields generally goes like this. Rather than returning cash to shareholders in the form of cash, or dividends, we are being 'rewarded' by companies plowing money into share buybacks. Is this "new math"? Because dividends are taxed at the capital gains rate of 15%, I would like more income. What a great time to reward people that OWN YOUR COMPANY. Send them a check with low tax consequences. It sure beats earned income with tax rates approaching 40%.

Why then, do companies buy back stock with cash, often borrowed cash, instead of sending me a check? It is earnings manipulation and financial engineering in a simple form. Company insiders reward themselves with stock options and dilute the interest of shareholders. They then buy back the shares, offset the dilution, which enhances earnings per share.

The acceleration in money supply and credit growth that has now gone parabolic, started in 1995, the same year that the 3%-6% stock market dividend rule broke down. The sum of the financial engineering is that we create more money for companies to 'reward' shareholders by buying shares with borrowed money. All I can say is "where is my dividend check?"

#2: Bifurcation

The split between the "haves" and the "have not's" seems to be accelerating, and the bifurcation takes on many forms.

The stock market is bifurcated when some of the stocks are doing well and some of the stocks are doing poorly. This is occurring now as the shares of financial companies, retailers, homebuilders, investment banks and REIT's get hammered while shares of energy companies, like Exxon and Schlumberger, and infrastructure companies, like Jacobs Engineering and Fluor are doing very well. This is due to the fact that countries that used to be considered 'emerging markets' have now turned into 'developing nations', like India, Vietnam and China to name a few. These countries are developing at the very time that the USA is suffering through a credit crisis, the depth of which is still unknown, and will likely be far worse than anyone imagines before it is all over. (I will write directly about this in my forthcoming look at what we expect in the 2008-2009 period).

The weakness of our overleveraged asset-based economy is just beginning to surface. This helps to explain the fact that financial companies are under the most pressure. Developing economies like China continue to build out infrastructure which could slow when we go into a recession. The shares of the companies in many of these countries already discount growth, so while I see the economic strength of these countries and acknowledge the bifurcation, it is hard to commit money to these markets at such stretched valuations.

Another bifurcation is growing between those that have significant wealth and those that have little wealth at all. Many people tell me that 'it is different this time' (I seem to have heard THAT before...), and that the growth in countries like China are insulated from the problems in the U.S. When looking at the developed countries that China relies on to export their cheap goods to, we see that these countries are losing economic momentum and may even already be in recession. I can only wonder what will happen to these over-heated markets. Will they win in the long run? It is possible, but it will take many years for the USA to get its financial house in order and clean up the leveraged mess that we now call our financial system. The bifurcation train is rolling down the tracks and is accelerating in my view, which leads to #3 B-Bailouts.

#3: Bailouts

Ever since the stock market bubble began in 1995, and money supply and credit growth took flight, we have had to increasingly bail investors out. In 1997, we had a currency crisis that first spooked investors that the world's markets were becoming increasingly intertwined, a trend that has only increased as nearly **ONE HALF**

OF A QUADRILLION DOLLARS OF DERIVATIVES HAVE BEEN CREATED WORLDWIDE SINCE THEN. Yep, half of a quadrillion dollars—that is NOT a typo.

In 1998, it was Long Term Capital Management (LTCM) which was one big, unregulated, leveraged mess, but thankfully an isolated player. Then, the tech bubble blew apart and you would believe that lending standards would improve and credit growth might slow, but no. We have become so addicted to debt that like someone addicted to heroin, we must produce ever increasing debt each day to keep the levered mess afloat. This debt has to be serviced, meaning that we still have to pay the interest charges.

What do you get when you add loads of new money, loads of new credit, moral hazard cards, poor lending standards and a housing bubble? A really, really big mess. Since 2006, 200 mortgage lenders have folded up shop, and I suspect that one day we will see a big one go, possibly Countrywide Financial. Just taking one look at Countrywide's balance sheet makes me want to curl up in the corner with a blanket.

Many of the housing related companies in portfolios are already technically bankrupt. This leads to more bailouts. The US Fed and European Central Bank (ECB) pump the system full of fresh money daily just to stop the systemic risk from taking over, but I believe it is inevitable. Regarding the Bush/Paulsen sub-prime bailout, I feel bad for the folks that need bailouts. I feel bad that they borrowed more money than they should and that they were taken advantage of by predatory lending practices that still exist today. Then again, I respect those that have prudently managed their finances, lived within their means, saved money and didn't take second and third mortgages to pay for expensive toys and wonder why they must pay for the mistakes of others.

When I make an error or buy a security that falls in price, I am not saved by Mr. Paulsen and the Fed. Where is my check? While being interviewed by Fox Business News last evening at the Festivus, I was asked about the fairness of the bailout? I responded that not only is it unfair to prudent investors, it is contractually unfair to investors on the other side of the trade who are holding adjustable rate debt they had purchased expecting a high coupon in 2008 and 2009. These investors should not be bailed out for taking excess risk any more than the people that took the loans, but in a Democratic society, they should at least receive the contractually obligated coupon income they are due for taking the risk of buying sub-prime assets in the first place.

As a frequent buyer of Ginnie Mae and Fannie Mae Adjustable Rate Mortgage securities on behalf of myself and my clients, I fully expect Ginnie Mae to pay me a higher coupon if interest rates rise and to pay me a lower rate if interest rates fall. This risk is contractually stipulated up front and we pay certain prices based upon some simple interest rate assumptions. If Congress will bail out sub-prime borrowers, will they also bail out FHV/VA borrowers if their interest rate rises? If they do, is it possible that my bond can ONLY FALL IN COUPON? Surely, some of the FHA/VA loans will experience higher default rates if rates rise. Does this mean that Ginnie Mae can simply tell me "too bad Mr. Sedacca, we are going to penalize you and your investors so that the borrowers can lock in a lower payment"?

If this bailout passes, and the SIV (structured investment vehicle) bailout passes, I may have to re-consider my entire investment philosophy. If poor choices are not met with consequences, then my investment philosophy needs to be redrafted. Borrowers that lied about their income and balance sheets should suffer the naturally occurring consequences. And certainly, those lenders that were predatory should be fined and/or closed down. Banks and dealers that improperly priced their mortgage related bonds should now feel the consequences of their actions. But this bailout has gone one step too far, and we cannot go down this road indefinitely. There will likely be a day in the future when a problem becomes too large to bail out.

#4: Bankruptcy

While studying macro- economic theory for my major in college, we were taught about the 'business cycle', a simple concept. During boom times, lending standards become too easy, which encourages borrowers to take on excessive risk and become a prime candidate for economic failure. This is how 'Social Darwinism' works. After an economic downturn ends, lenders tend to be rather cautious about their lending standards as they have most likely been recently stung by recent delinquencies on their lower quality loans in the end of the previous cycle.

You might call it LIFO lending (last in, first out). The loans that were made at the beginning of the cycle, which had better higher standards to begin with, tend to withstand an economic downtown much better. The increased defaults that are now occurring are a direct result of lending standards having deteriorated to such a low level and with so much leverage attached. The financial alchemy that created all of these low standard derivatives is beginning to evolve into a 'credit unwind on steroids'. The credit unwind is likely to last longer and cut deeper into the economy than most expect. It sounds cold-blooded and heartless to say this, but those that overspent and overleveraged should go bankrupt. That is how cycles are supposed to work.

I will be spending quite a bit of time researching bankruptcy over coming days and weeks in order to be prepared of how to deal with the next wave of defaults. Yes, there will be another wave of defaults. This view explains why we continue to avoid most credit risk and will continue to focus on quality until all of the credit problems are known and we are adequately compensated for risk. This philosophy has served our investors well during this credit crisis and I look forward to the day when the coast is clear to once again take risk.

Bailouts delay 'Social Darwinism' and the natural business cycle. Artificially delaying the cycle will create a more horrific final event. This is a dire situation, but there continue to be opportunities in this market environment. We will continue to look for value in the credit and equity markets as they present themselves, as in the case of the Fannie Mae and Freddie Mac Trust Preferred shares.

Happy Holidays to you and yours.

Best regards,

Bennet Sedacca
President

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