

**Musings**

January 5, 2009

**Dorothy and the Asteroid**

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In late 2007 a tornado picked us up like Dorothy and ever since we have been buffeted in swirling darkness. Every so often it seems we might touch down, softly or not, but so far, every seeming haven has been obliterated by brutal winds from a new direction. We are so long in this storm that we would settle for a hard landing in Oz – wicked witch and flying monkeys et al – if only we could feel the solid ground beneath us once more.

In the post-election month just passed, the winds abated a bit and the air smelled hopeful. Many metrics of illiquidity and chaos eased just slightly. Our storm is top of agenda for policymakers everywhere and vast resources and experimentation are dedicated to restoring a fragile order. Maybe our wild ride will end soon? Bruised and disoriented by our topsy-turvy trip, might we regain our sense of self-control? When we do, what will we see?

An evil Land of Oz it is, and it will be hard to face. Dorothy found everything new and wondrous; she had no cognitive dissonance, aspiration or regret. Dorothy blamed no one; she had no rage. Dorothy had steady allies and opponents of steady malevolence. Her Oz was simple and bright.

Our Oz is dour. Remembrance and regret are with us always. Yesterday's hero is a villain today. Our honored institutions have been revealed to be all fake façade; every promise is shown a lie. Oh woe is us! How far we are fallen from the glory that was us!

We are going to be here a long time – might as well unpack our bags and settle in. So repeat after me: "what went before is gone. I'm over it; shakin' it off! Gonna stop whining and wishing and blaming and trying to understand. Toto we are not in Kansas any more!" We will chant this mantra until we can all get focused on the Land of Oz as it is *right now!*

Markets embody economic reality – macro and micro, long-term and short-term – but they are upset by "asteroids" (as in "when an asteroid hits, all things correlate at -100%") and swamped by herd behavior. Theorists sometimes assert that a market is a microcosm. Baloney. Each market is a mirror, manufactured by Man and flawed, reflecting only a slice of reality. It's quicksilver, distorted differently at different times in accord with its internal rhythms and external stresses.

Economic reality evolves continuously and slowly, but distortion is fluid and discontinuous. As a result, markets embody the contradictions of quantum mechanics: they are highly accurate as of *right now* yet they are never certain and they can change in an instant. To understand this we need to accept contradictions: *The past is prelude* in that regression to the mean is one of the two powerful forces in the physics of markets (expected value of money expressed as interest rates is the other), and history teaches quite a lot. Yet the *immediate* past is not only *not prelude*, it is *noise* and the closer you look the more chaotic it is revealed to be. A koan for our time for sure!

Understanding our storm and counting the damage will not help us cope. The asteroid swamped the internal dynamics of most markets, rendering them chaotic. The particular herd configuration at the time – all of us gathered high up on the slope of leverage – forced a stampede. Instead of

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sorting the relative value of the items within the market, each market was swamped by radical changes in the *actionable* value of the market *in toto*. Markets correlated to a degree we have not seen in decades, or ever (depending on how one calculates real prices globally over 200 years). After more than a year of this capital flow tempest, markets are recovering and will soon be able again to assign relative value. As better investments lay claim to available liquidity, more liquidity will be teased into the market. But what price level will be revealed?

We believe long term trends will rule. A graph of equity market real prices over 200 years has two big kinks. After a century of flat prices, FDR invited inflation to become a permanent part of our world and for fifty years we encouraged growth of the greenback as the global reserve currency. The effects of this kink are permanent (so no, we should not expect complete global or national monetary collapse). The second kink in the early 90's marked the dawn of easy money – the culture of leverage that lasted until 2007. This is not permanent – it is a net asset bubble, if you will – and it will revert to the longer trend. Here in our post-storm Land of Oz the equity markets will oscillate around an 800 S&P with low annual real growth (-1% to +1% near term).

As to the near term, who knows? In the Great Depression equities dropped 50% then rose 50% then dropped steadily for many years. If this gives you pause as you raise a glass to the New Year, it should: check out "The Aftermath of Financial Crises" from Reinhart (U/Maryland) and Rogoff (Harvard). Beware the false horizon, the mirage of swift rebound. We may be ADD, but reality is not necessarily so. The research supports the view that the rate of change is very high during the run-up to a banking crisis, and that the aftermath may last for decades.

### **In 2009 almost nothing will work very well**

An Imelda-load of shoes has yet to drop in our accountant-led global de-risking. The forces that brought banks low and buried the brokers are not done. Looking for trouble in the US? It will be all about bonds. A lot of SIVs, SPVs (lets just say S---) may have been repriced, but not much real progress has been made re-marking insurers, commercial real estate, the states and municipalities. There is undisclosed and unrecognized bad news in consumer and commercial credit and corporate debt. Late in the year expect a cascade of failing LBOs. Looking for trouble abroad? You will find it in Euroland, where the putative regulatory structure is a house of cards.

On the other hand our Federal recapitalization is well funded and now buys equity, impaired assets and structured participation in toxic pools. What else will Washington do? It will use its printing press to enforce rate spreads by buying longer dated paper, commercial issues at a discount, and auto companies in mid-shotgun-merger. A positive note: ARM rollover risks may not be as great as forecast, since inflationary policies make it likely that 2011 rollovers will be in-the-money and structurally low rates could reduce the forward cost to manageable levels.

In this *year noir* Oz will start a decade-long realignment of the labor force. Unemployment will reach 11% in the second half despite massive subsidies for unions in construction, manufacturing and government service. Real wages will fall and productivity will rise as job tenure lengthens and employers refuse to expand the workforce (despite weak and silly tax incentives). \$1.2 trillion in Bush/Obama money will be wasted because of a negative multiplier from union overhead and porky politics – each Federal dollar will be worth 80¢ instead of the dreamy \$1.30. US GDP will fall in 2009 and remain flat in 2010.

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Consumers and managers alike will hoard cash. Corporate balance sheets, flush with cash, will get flusher. Without predictable returns and with no way to raise replacement capital, Obama's tax incentives will not unlock corporate coffers.

Congress will second-guess corporate jets and sales incentives, promote "greening" and generally follow the loony ideas of Birkenstock-clad academics (recent Nobel winners included), not one of whom has ever done anything but talk and write to an audience of sycophants. These quislings will aid and abet the worst managers in the world as they set about to make the free markets more "fair" using Federal money, thus making serfs of the next generation.

Elsewhere, economies of emancipation like China and India will continue to grow, but the good effects will be contained within their borders. Governments will intervene to support a minimal standard of living (two meals a day instead of one) and a smidgeon of capitalist opportunity. Many countries will hew to the ideals of Deng's Socialist Market Economy, and they will mostly succeed. We will get little benefit *despite a concerted weak dollar policy*. Their growth will utilize the cheap capacity in one regime to fill the needs of another. Why would we get any part of new consumer demand? Do we really think the dollar can fall far enough to make US labor competitive? It's a perfect set up for the only thing worse than domestic moral hazard: punitive trade barriers.

Many emerging markets have strong balance sheets and less fragile domestic production, but no matter how you add it up, their trade does not move our needle in the Land of Oz (We might better click our heels and relocate to Brazil). Developed economies will be no help either. Trade or currency – pick your metric – for the next three years it will be about *relative* inflation, *relative* industrial malaise and *relative* standard of living.

We may find our foreign policy reduced to tatters along the way. After all, war solves our need (inflationary spending) and the combatants' needs (under-class employment). Among the combatants might be India/Pakistan, China/Russia, Korea/Korea, Iran/anyone, and Africa/itself. We might build a huge "defensive" army (an FDR trick to cut unemployment and boost demand) or we might provide material support big time to one side to restart manufacturing (FDR again).

So where might the sun shine in 2009? Assets. Delevered or relevered or just better disclosed, net assets on balance sheets may provide stability by midyear. When we get a grip on the earning potential in a recession, RoI and RoA will be important again. Re-read Graham and Dodd (tip o' the hat to Jim Grant for a new intro) to rediscover your faith. A massive asset rebound is certainly built in to the continuing bail-out; the question is when it will start to be reflected in US equities.

### **2009 will be a year of revenge from clients**

Great investors exploit the ebb and flow of distortion through time by picking where to start (reality or market) and placing bets. Invariably they regard the market with a wary eye: they cultivate a sense of irony and practice detachment even when all around them are in frenzy. They do the "right thing" according to their philosophy, and try not to obsess on today's portfolio prices.

Applying an investment process backwards does not work, yet many have been doing just that as if wartime urgency excused them from straying far from what they know. Many are violating the processes and cycles that are at the root of any hope of success – in effect, professionals are

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making themselves amateurs. Hey guys: get back to the basics *as you know them*. The old bromides are boring – “invest don’t trade” “act on conviction” “trust thought over feeling” “expect but don’t predict” “yada yada yada”. Only in what you know is true will you find your mojo again!

Detachment, dispassion, irony – not much of these in Washington or on Main Street! Real clients live in our grim land – households and institutions with promises to keep now have what to meet those needs? a whole lot less money, a whole lot less confidence, and a whole lot less trust.

Clients are furious. Institutions and individuals took advice and it did not work as promised; they bought absolute return and swallowed “aligning” fee structures and got neither; they signed on to “target date funds” and got a crash landing; they sought safety in munis and got nauctions; they thought money funds were money, and found out otherwise; and \$50 billion bought perfect returns year after year – and got bupkis.

And who helped them do this? A legion of agents, consultants, fund of funds, feeder funds, brokers and introducers. Portfolio managers – especially hedge managers – misrepresented both the risks inherent in their portfolios (a forgivable error) and the real efforts they were undertaking to mitigate risk (an unforgivable fraud). To happy financial effect, the language of hedge portfolio managers beguiled rather than informed the clients and their smug and lazy agents.

Youth, ambition, hubris, greed, sloppiness and deception: trusting clients have a hard time sorting these evils from mundane errors of omission and the effects of the asteroid itself. For two decades clients have been taught by their experiences and their advisors that *most* of a diversified portfolio will go up each year. They learned to revere beta as if it were alpha. Confusing luck and skill is awfully easy, and it results in the expectation of low correlation among portfolio techniques, and an over-reliance on diversification for risk management.

In 2008, clients were vulnerable, panicked, helpless – they felt shame and fear. That day is done and with 2009 will come a reckoning of huge proportions. After a quick and narrow collapse of the equity markets in October 1987, in 1988 about three years worth of market shift changed hands. Intermediaries, insurers and money managers were made and unmade by the wrath of clients. We hear Gabriel’s horn ablowin’.

Institutionally, there will be nowhere to hide. Pensions are in a squeeze: contributions cannot rise, liabilities loom large, and the portfolios are 90%ish long, 80%ish US, 75%ish liquid. Committees will try to reconsider asset allocation – no easy trick when all consultants say the same thing. Our guess is that most will not bother with real triage, they will just shoot the wounded. In their haste, they will also shoot the healthy – as witness recent panic sales of private equity. Denominator effects are no excuse. Asset allocation is not a calculation; although it explains performance it does not create alpha unless it is done very well. Damn few firms – and no committees, none – can do it well.

For non-pension institutional portfolios including foundation and endowment, family office, SWF and others the three questions are *whither Alts?* Withering, fast! *What about Real Estate?* Leverage that amps Inflation spreads – oops! *How can we meet rapidly rising demands?* This one requires a less trusting but still very aggressive asset allocation, with world class risk

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management. Very few can do this, and fewer still were unscathed by failure in 2008. To those few will go huge rewards.

Family behavior is harder to predict. The rage is palpable: *throw the bums out!* What is hard to predict is where the money goes. Annuities, yes; money funds, yes; individual stocks, no; munis, maybe; everything else we are clueless about (rage is so hard to plan!). Fund flows likely will be healthy for five-star funds only, with negative flows increasing for low ranked funds to twice or three times the outflows of 2008. In the aggregate, ETFs will grow and managed accounts will continue to gain share, but now the magnitude of share-shift may be huge. As a corollary source of confusion for clients, we note that the annual migration of brokers has darkened the sky already and may in 2009 be much more profound since so many of their rookeries have burned.

While clients sort the quick from the dead, we also expect *Regulatory rage* to be widely directed, and we fear the unintended consequences. Our "legislation by sound bite" usually assures that the powerless are awarded a day in the news but nothing changes. When millionaires are fleeced – contributors to campaigns and charities – expect less weeping on camera but a lot more action. We expect fiduciary accounts to be further intermediated. Starting in 1974 it has been increasingly difficult to serve as both manager and broker for a client; we fully expect the SEC to require a certified independent custodian to provide reports to clients. This is a good idea, so it will not be considered or implemented by the Cox SEC. Right after he packs up his crayons and sippy cup, though, we foresee prompt action. During the inauguration, the Staff – the long suffering hard working dedicated Staff – may celebrate with confetti made from his absurd proposal to consider insurance to be a security (and a credit default swap not?).

Elsewhere, there are ideas dumb and dumber to consider: Legislate mortgage rates, LTV, sales practices, etc.? Ban securitization? Forbid foreclosure or legislate exchanges? These and other simplistic give-aways will be hotly debated. It is a Democratic administration, after all. There are literally hundreds of bad ideas being put forth and there is simply no way to guess at the reaction of the Obama administration. Early indications are positive, but if getting elected is about saying yes, and seeking ideas, governing is about saying no and excluding ideas.

ECNs, exchanges and settlement corporations may finally get their due reward. *Counterparty risk* was widely held to be virtually nil in July of 2007, and since has been *the biggest asteroid*. Devaluations only wounded our banks and brokers. It was the downward spiral of confidence and counterparty flight that administered the *coup de grace*. We hit a nadir late last year when the Uncle Sam himself promised to pump in money and *for the first time in 150 years* no one believed him until the money was in hand. *Wow, that's skepticism!*

Derivative and bond trading will change: in time no such trade will occur off-exchange over the counter in the dark, and no position will exist except subject to one or more pricing mechanism from an uninvolved source. For those of us who were around at the formation of DTC this is a dream long deferred. Now that everyone understands the consequences of opaque markets and optional marks, maybe thirty years of failed efforts can be reversed: With regulatory help the exchange/CNS movement might finally be triumphant over rating agencies.

Elsewhere on the Street, we see convulsive change. Consolidation of US banks will accelerate, and it will not be gentle. Deposit consolidation will be part of it, as will scale benefits. What will not play a role is talent; we are at a low point in the pay-for-motivated-people cycle.

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Global footprint is important to many businesses. With the dollar in a relative strength battle with other currencies while we print and print and print, it is likely that US companies will be sellers. While many industries are truly global, it is clear that banking is not – banking is comprised of activities that are national/local (deposit taking, household investments) and activities that are universal/global (proprietary trading, portfolio management). Viewing businesses as client-centric or process-centric is not useful, what matters is where the power is, the gravitational pull. If the business is hub and spoke meaning “value at the rim, control at the hub” it is national/local; if the business is hub and spoke meaning “sales at the rim, value at the hub” it is universal/global. We now know that VaR is not a good way to count risks of *either* type of business.

Any business that fails to fit into the paradigm is *not banking* and will be sold or closed, by all competitors (the strategies will correlate big time!). Competition among big banks will be very ugly indeed. JPM and Wells can each provide exactly the same services and each is Fed-owned, and each has the same imperative to grow without excess risk: this will be a cat-fight nationwide!

Asset management (institutional and private wealth) businesses will be in the corporate development crosshairs as a result. Private equity and a few strategic consolidators will be quite busy this year with asset management M&A opportunities.

We believe Private Equity will undergo a renaissance in this and next year, but only because it will ruthlessly retool itself. The era of financial engineering is done for at least five years. To do deals in the Land of Oz will require three things that are in short supply today: industry knowledge, strategic viewpoint, and managerial skill. NONE of these has been required for over a decade. Clients have confused deal making for wisdom, and awarded more and more money to buyout shops who are proud to call themselves generalists. Those clients will get what they have long deserved from mega transactions made and managed by generalists.

Private equity returns are derived from entry price, leverage, growth rate and exit price. For over a decade, entry price and growth rate have mattered least of these. No more. In a good entry price environment with little leverage, it is growth rate that rules and that requires strategy and expertise and management in the boardroom. Holding periods will stretch to eight years and longer, so quick fixes will not do at all – no IPO to the rescue.

We believe returns for 09/10 vintages will be better than expected not only because PE has the money, and entry will be reasonable, but because of two other factors. First, PE firms will restructure/affiliate/partner to get access to industry experience – and the payoff will be profound. Second, the leverage rate that actually drives client IRR is *not* the leverage at deal-time but the average leverage ratio across the holding period. Financial savvy in the boardroom will exploit banks – and everyone on Wall Street is one now – to the advantage of investors.

So “only go down to the end of the town” with those who know where they are going and why.

As they say on Hill Street Blues (which went off the air just before the '87 crash), “Be careful out there!”

DHP