

Roots and Ramifications of the Financial Crisis

2008. Decades from now, the mere mention of the year will conjure painful memories of the financial tsunami that came ashore last fall. As we put our *annus horribilis* behind us, it's perhaps a good time to reflect on the root causes of the crisis, what's involved in cleaning up the mess, and how equity investors should proceed.

Roots of the Crisis

Looking back, much of the economic and political history of the last two-and-a-half decades appears to be a search for the new growth engine of the American economy. By the end of the 1981-82 recession, it was clear that the decline in U.S. manufacturing was irreversible. As the end of the downturn came into sight, the stock market roared back to life, ushering in the LBO boom of the mid-to-late eighties, a period symbolized by fictional financier Gordon Gekko's pronouncement that "Greed is good." While it was too early for anyone to crown finance as the centerpiece of the American economy, the LBO era and its interplay of debt, financial engineering and the celebration of wealth foreshadowed much of what was to come.

For a time in the 1990s it seemed that technology would take the mantle that manufacturing held for so many decades. From at least the time of the Netscape IPO in the summer of 1995 until the tech bubble burst in the spring of 2000, tech was booming and a new era seemed at hand. All was not, of course, what it seemed, and while the Internet and other technologies continue to change our lives, the leading role of technology in the economy faded as the Nasdaq descended from 5,000 to 1,100.

After the demise of the tech bubble, the seemingly coordinated behavior of policymakers and others in the U.S. and abroad caused finance to ascend in a way that was only hinted at by the 1980s¹. The interplay of actions was so powerful that one imagines Alan Greenspan, Jiang Zemin, Robert Rubin, and George Bush gathering in a room early in the current decade rehearsing roles in the drama that was to come. The Fed's role was to lower the fed funds rate to 1% and keep it below 2% for nearly three years (based on the wildly pessimistic assumption that deflation threatened). China's role was to enable these low rates by funneling its prodigious trade surpluses² into dollar assets (Treasuries in particular). Wall Street's role was to take on massive leverage and stoke the private equity, hedge fund and (most consequentially) securitization industries. The role of the White House was to embrace financial deregulation (with assists from the prior administration, the Fed and the SEC), and to push hard for the rapid expansion of homeownership for both ideological and partisan reasons. Congress ratified deregulation with the 1999 repeal of Glass-Steagall and tried to outdo the White House in its zeal for homeownership. American consumers had a huge role as well, which was to take on ever increasing mortgage debt and to send a healthy chunk of the cash back to China in exchange for imported goods.

¹ Kevin Phillips, in Bad Money, uses the term financialization to describe the ascendance of finance over the last quarter-century. Much of this section is influenced by Phillips account.

² These trade surpluses were themselves the consequence of China's policy of keeping the yuan undervalued to assist its export industries.

The results of the Washington/Beijing/New York collaboration have by now been well documented. There was a massive expansion of debt as consumers and investors alike levered up. The vehicle for much of this debt was residential real estate, with more and more of the mortgages going to subprime borrowers as underwriting standards declined. To perpetuate the supply of borrowers the mortgage industry became more and more "innovative," relying on dubious appraisals, limited or no documentation and teaser rates that made homes temporarily affordable; never before had subprime borrowers had such easy access to mortgage financing. In a manufacturing economy, overinvestment leads quickly to overcapacity and falling profits. In a finance-based economy nearly the opposite is true. Overinvestment in the mortgage industry led not to overcapacity, but to a housing bubble that fed on itself. The expansion of leverage enabled by low interest rates was so powerful that Wall Street firms could use securitization operations to turn the torrent of subprime mortgages into a prodigious supply of asset-backed securities while simultaneously funding ultra-leveraged hedge funds that purchased the securities. Increasingly leveraged consumers created the supply. Increasingly leveraged investors created the demand. Everyone made money as long as interest rates stayed low and housing prices went up. When housing prices finally stalled in late 2006, loans predicated on ever-rising home values began to sour and the securities they backed were infected. Mortgage companies, investment and commercial banks, hedge funds and other companies with exposure to over two trillion dollars of shaky mortgages were forced into massive asset write-downs that ultimately led to the fire sale of Bear Stearns, the government takeover of Fannie Mae, Freddie Mac and (effectively) AIG, and the bankruptcy of Lehman Brothers. By early last fall, in the wake of Lehman's bankruptcy, the very core of the financial system had been shaken and the economy was descending into a deep recession.

Cleaning Up

Chronicles of the financial excesses of the recent years have properly focused on housing. However, the debt mania manifested itself in other ways as well. Commercial mortgages were predicated on sharply increasing rental streams as far as the eye could see. Private equity firms financed takeovers with debt that was every bit as imprudent as the worst of the subprime mortgages (oddly, or perhaps not so oddly, "payment-in-kind toggles," which allowed for negative amortization in the high-yield bond world even sound like "pick-a-pay loans" that allowed for negative amortization in the mortgage world). Meantime, hedge funds and their prime brokers thought nothing of ten-to-one leverage³. By 2006 private debt in the U.S. had exploded to \$36 trillion, tripling in a mere 12 years. The housing bubble was simply the biggest piece of a much larger debt bubble.

With the debt bubble burst, there is now a massive cleanup process, whereby shaky debt is either restructured or written off and lenders holding the bad debt (or investors holding securities created from the debt) must be recapitalized or allowed to perish. The cleanup process is likely to be protracted for several reasons. First, there are many sectors, such as commercial real estate and credit card debt where problems are just now beginning to bubble up. Second, the housing-related debt is complicated by the question of when and at what level housing prices will bottom. Finally, while corporate debt can easily be restructured, mortgage debt cannot. One of the biggest challenges of the Obama administration will be to find a mechanism whereby the many millions of borrowers who owe more on their mortgages than their houses are worth can restructure their debt, perhaps by incentivizing the mortgage holders to write-down large chunks of principal. The fact that the mortgages have been pooled and then carved into bonds now held by thousands of investors further complicates matters. Bond documents do provide a fair

³ In the meantime, leverage at investment banks, which had been limited to 15-to-one by the net capital rule went to 30-to-one or higher in the self-regulatory regime authorized by the SEC in April of 2004.

amount of authority to mortgage servicers and/or trustees to modify loans, but the servicers and trustees will have to be cajoled into exercising that authority.

In concert with debt cleanup, policymakers must resuscitate an economy that fell off a cliff in the fourth quarter of last year as consumers and businesses pulled back sharply. With half a million jobs disappearing a month, we're in the midst of a nasty spiral where mounting unemployment undermines consumer confidence which further depresses consumer spending leading to further waves of layoffs. This downward spiral provides the logic for the \$825 billion and counting stimulus package the Obama team is pushing through Congress. Additional stimulus will come from lower gas prices and favorable resets on adjustable rate mortgages. At some point in 2009 or very early 2010 all of this stimulus should be enough to get GDP into or at least close to positive territory. Robust growth may not be in the offing for some years beyond that as the economy will continue to be weighed down by the ongoing debt cleanup.

With the federal government shelling out trillions of dollars between bailouts and fiscal stimulus, the big questions are, Will there continue to be an appetite for all the debt the Treasury will issue? And, With the Fed printing money at a rapid clip, are we in for a bout of inflation down the road? There is fear that the Chinese will at some point slow down their purchase of Treasuries. That's conceivable, but it's important to remember that China is hugely dependent on exports and the U.S. its leading export market; continuing to lend to the U.S. is in China's self-interest. Eventually, a return of inflation does seem inevitable given the aggressive expansion of the Fed balance sheet and Treasury borrowings. One hopes that Ben Bernanke or his successor will remember the lessons of the 1970s and keep a sharp eye on inflation as the economy begins to recover.

What's an Equity Investor to Do?

We now interrupt this essay for a brain teaser. Imagine a one-stock portfolio invested over ten years. Let's say 1,000 shares of American Widgets Co. (AWC). Now consider two scenarios. In the first scenario AWC's share price is \$100 on day one and goes up 2% a year. AWC pays a dividend of \$5 a share and that too goes up by 2% a year. Dividends are reinvested. The second scenario differs only in that on day two AWC's share price plunges by 80% to \$20 a share; as in scenario one, the share price then goes up by 2% a year, but from that lower base. Question: At the end of ten years, how much less is the portfolio worth in scenario two (80% share price drop) compared to scenario one (no share price drop). Answer: it's not; scenario two results in \$22,616 compared to \$19,838 in scenario one. How is that possible? Through the power of dividends reinvested at a low share price. The ending share price in the first scenario is \$151.57 compared to \$30.31 in the second. However, in the second scenario the number of shares owned at the end of ten years is over five times greater, 928 vs. 163⁴.

The example above is extreme. But, the dynamic is powerful and has a very significant effect on real-world investment returns. In our example, we used dividends, but the more pertinent metric is free cashflow. Free cashflow is the total cash a company generates less capital expenditures for new equipment and the like. Free cashflow represents the amount of cash that is available to be returned to shareholders. In the first half of the twentieth-century, free cashflow tended, on average, to be fully paid out in dividends. In more recent decades a significant portion of free cashflow is devoted to acquisitions, which were much

⁴ Our example assumes that dividends are paid out once a year at the end of the year. Quarterly dividends would change the numbers a bit but not the overall result. To get an appreciation for how the counterintuitive result is possible, consider what happens at the end of the first year in scenario two. The investor receives a dividend of \$5. This dividend is reinvested at a share price of \$20.40 (the \$20 share price from day two, plus 2% appreciation over the course of the first year), resulting in 24.51 new shares. With the number of shares increasing at a rate of 24.5% a year, the number of shares accumulates rapidly.

less common before the rise of “conglomerates” in the 1960s, and share repurchases, which were very rare prior to 1983⁵. In the hands of prudent managers, free cashflow used for share repurchases and sensible acquisitions in a low share price environment have the same powerful impact as reinvested dividends. To be sure, many CEOs have been known to buy high and sell low when it comes to deployment of free cash. But if one is selective, it’s quite possible to find stocks that should be able to leverage the power of reinvested free cash to deliver excellent results over the next ten years and beyond, in spite of the difficulties of the current economic environment.

To help ensure excellent returns, investors should seek stocks with several characteristics. The most critical is a high free cashflow yield. In the AWC example, the dividend yield after the share price drop was 25%. While it’s not possible to find stocks with sustainable free cashflow yields of 25%, it’s not at all hard right now to find companies with free cashflow yields in the range of 7%, 8% or more⁶. It’s hard to get good data on historical free cashflow, but given that dividend yields historically averaged around 5% prior to the advent of acquisitions and share repurchases, that’s a pretty good estimate of a normal free cashflow yield. By comparison, 7% or more is extremely attractive. In addition to a strong free cashflow yield, it’s critical to find companies with strong balance sheets. Given the perilous state of the bond and loan markets, companies with weak balance sheets—even assuming they can avoid a recapitalization that badly dilutes shareholders—may find heavy demands on free cash either to reduce debt or pay stepped up interest rates. It also helps to find companies with reasonably predictable earnings and free cashflow to ensure that anticipated future free cashflow materializes. Finally, since much of the free cash will be reinvested at the discretion of management through acquisitions and share repurchases, a track record of wisely deploying free cash (buying low and selling high, not the other way around) is also important.

In our judgment, there are many large, familiar companies that meet the above criteria. Portfolios built around these names should perform very well going forward. If price/earnings and price/free cashflow multiples stay low⁷ or even decline, these stocks are likely to benefit from the leverage of reinvested free cash⁸. If and when multiples return to historical levels, that will be icing on the cake.

Perhaps, we can summarize by trotting out the old slogan that “cash is king.” As companies and consumers deleverage and bloated asset prices sink, those with cash-rich balances sheets and cash-generating operations will be shielded from the worst of the pain and will be well-positioned to take advantage as opportunities arise. Equity investors looking to weather the present storm would do well to seek their shelter.

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⁵ SEC rule 10b-18 was enacted in November, 1982 and provided companies with safe harbor guidance for repurchasing shares without exposing themselves to litigation over price manipulation.

⁶ Free cashflow is much lumpier than dividends, i.e. subject to short term swings. For this reason, it’s important to try to estimate some sort of “normalized” free cashflow in assessing stocks.

⁷ There’s currently a vigorous debate among investment professionals about just how low price/earnings multiples are. Our preferred metric is the S&P 500 index relative to normalized earnings. By our estimate, this stood at around 13 at year-end, compared to the historical average of around 15: low, but not extremely low.

⁸ For example, a stock with a steady 8% free cashflow yield can, based on reinvested free cash, withstand an immediate decline in share price of any amount without any material detriment to ten year returns. Of course, a share price drop may not be immediate and the further along it is in the ten year time frame, the more difficult it will be to overcome. But, we are talking here about propensities, not certainties.