

## A brief history of financial insanity

"KLEPTOMANIAC, n. A rich thief." – Ambrose Bierce, *The Devil's Dictionary*.

How did we end up here ? The polite version would have it that the problems originated in what is euphemistically called sub-prime debt, which in itself represents only about 12% of the US mortgage market. It is becoming increasingly clear that over the last two to three years, too many lenders pretty much abandoned any discipline in underwriting criteria – just as Wall Street investment banks and US exchanges collaborated to abandon any discipline in underwriting criteria in the years and months prior to the dotcom bust. *Plus ça change..* Money was loaned out that never should have been. To this extent the current credit crisis shares common characteristics with previous booms and busts, specifically a sense of mania fuelled by greed and helped on its way by financial innovation, sleepy regulators and complicit participants from the financial sector, not least the ratings agencies. A growing number of delinquencies and souring debts is now infecting other parts of the credit markets and a variation of Gresham's Law, that bad money drives good money out of circulation, is ensuring that the more speculative or sloppy financial players are liquidating good assets to pay for bad ones. Equities would have been caught in the crossfire at some point, but since easy credit has also fuelled much of the private equity party, fears of a credit contraction are taking an inevitable toll on the mid- and small-cap sectors that were always the most susceptible to the LBO story. And in a twist appropriate to this bold new globalised trading environment, the victims are popping up all over the financial world's beaches: Bear Stearns "hedge" funds; Australian "hedge" funds and Macquarie; Germany's IKB; France's AXA Investment Managers..

So much for the polite version. James Kunstler, whose financial weblog carries a monicker inappropriate for repetition within such a family-friendly *milieu*, puts it a little more colourfully and forcefully:

"...a financial sector rigged for the falsification of reality eventually enters a danger zone where reality implacably reasserts itself, expectations dissolve, and all that remains is the sour odour of fraud..

" This long episode of market mania, running for seven years, was based on the idea that non-performing loans could be turned into money by removing them from their point of origin and dressing them up in respectable clothes -- like taking all the winos in downtown Los Angeles, putting them in Prada suits, and passing them off as the faculty of the Harvard Business School. It was a transparently ludicrous racket and the wonder is that America proved to be so utterly bereft of regulating authority -- not to mention plain decency and selfrestraint -- at every stage.

" It's really hard to account for the stunning failure of responsibility. What you had was a whole industry that surrendered the standards and norms that brought it into being and enabled it to function in the first place. Mortgage lenders stopped requiring house-buyers to qualify for loans; bankers stopped caring what stood behind the paper they issued; dubious loans were bundled and resold like barrels of rotten anchovies -- in such numbers that no individual stinking minnow would stand out -- and the barrels were traded up the line, leveraged, hedged, fudged, fobbed, and fiddled until, abracadabra, they were transformed into so many Tribeca lofts, Hampton villas, Piaget wristwatches, million-dollar birthday parties, and Gulfstream jets.

"It worked for the Goldman Sachs bonus babies, and the private equity

scammers, and for the corporate CEOs and their board members, and for the politicians who parlayed their votes into cushy lobbying jobs, and even for the miserable quants in the federal government's termite mounds of statistical reportage. It even worked for about 18 months for millions of feckless US citizens gulled into contracts for houses they could never hope to pay for, under arrantly false and ruinous terms."

It is a psychological function of markets that participants lose their minds collectively and then slowly recover their sanity one by one. Given that corporate credit spreads had become outrageously tight during the long, lazy bull market in everything, the only way that the greedier and more ill-disciplined members of the speculative community could hope to generate investment returns in excess of their management fees was through leverage – and so the hot money funds calling themselves hedged when they were anything but, perpetuated the rally just long enough to ensure that the pain would be universally distributed through the financial system when the music stopped which, notwithstanding Chuck Prince's recent hubristic bombast, it did earlier this summer. For fans of historical irony, just as in the LTCM debacle, some of the smarter money (for example Harvard / Sowood) got carried out on stretchers alongside the hicks.

Which takes us up to the present day. Given the current climate of heightened tension and uncertainty, G7 government debt probably enjoys a few more months of a 'flight to quality' bid, but could hardly be called cheap. Quality corporate debt is evidently in the process of being repriced so spread widening may not yet be complete. While the universal nature of the asset rally meant that selectivity could be thrown out of the window, the new environment calls for qualities that haven't hitherto been required: discipline, discernment and

prudence. Globalisation notwithstanding, the dispersion between returns from different national equity markets has demanded stock-level discrimination, and that requirement will persist. For investors still willing to trust third party managers, those same qualities of discipline, discernment and prudence deserve to trade at a premium (some hedge fund managers actually are hedged, for example). And we now break with tradition to mention a specific security. For those who believe that US financial stocks still have some pain to undergo, we draw your attention to something we discovered last week: the UltraShort Financials ProShares exchange-traded fund (Bloomberg ticker SKF US <Equity>). This ETF attempts to deliver returns equivalent to 200% of the **inverse** performance of the Dow Jones US Financials Index. Not that we would ever be drawn into activity like day-trading, but just for reference this ETF returned 6.6% last Friday. Needless to say it is not for widows and orphans, nor for US financial sector bulls.

Tim Price

CIO Global Strategies

Union Bancaire Privée, London.

Email: [timfprice@gmail.com](mailto:timfprice@gmail.com)

Web: <http://www.thepriceofeverything.typepad.com> [www.ubp.ch](http://www.ubp.ch)