GORDON PAPE INCOME INVESTOR SEPTEMBER 2008-09-16

TOO BIG TO FAIL?

Gavin Graham
Director of Investments
BMO Asset Management

What a week that was. British Prime Minister Harold Wilson once remarked that a week is a long time in politics. Well, the effective nationalization of Fannie Mae and Freddie Mac by the US government over the weekend of September 6-7th, was followed a week later by the bankruptcy of the 158 year old Wall Street investment bank Lehman Brothers and the agreed takeover of the "Thundering Herd" (Merrill Lynch), itself 94 years old, by Bank of America, only to be capped by speculation about a potential bankruptcy filing by what had been the world's largest insurance company, 89 year old American International Group (AIG) and concerns over the US' largest thrift bank, Washington Mutual (WaMU).

At the time of writing (Tuesday September 16, 2008), there is speculation that the US Federal Reserve (the Fed) may arrange a loan to support AIG, which, while not a bail-out in the same way as the arranged takeover of Bear Stearns in March by JPMorganChase or the "conservatorship" used to ensure that Fannie and Freddie's debts remained in good order, would have the same effect of not putting AIG into Chapter 11 bankruptcy like Lehman, with all of the attendant disruption and losses that have ensued for the debt holders and counterparties. This would be disappointing to many observers who were pleased that US Treasury Secretary, ex Goldman Sachs chief executive Hank Paulson, had finally returned some of the disciplines of capitalism to Wall Street by letting Lehman go bankrupt and not accepting that it was "too big to fail". What has been well described as moral hazard, whereby investment banks and brokers took greater and greater risks in pursuit of enormous profits for themselves, yet expected to be bailed out from the consequences of their greed and recklessness when the cycle turned by interest rate cuts and the provision of ample liquidity, had met its deserved comeuppance.

Some observers trace this cycle of aggressive and foolhardy risk taking back to the rescue of Long Term Capital Management (LTCM) in 1998, when the Fed effectively rescued a massively leveraged hedge fund because the rest of Wall Street had many of the same positions and would have faced bankruptcy if LTCM had been allowed to fail. Roger Lowenstein, who has written probably the best biography of Warren Buffet, described wonderfully how essentially LTCM had only one trade idea-that the spreads between riskier assets such as Italian government bonds and safer assets such as German bonds would narrow, and used massive leverage (over 80 times its capital) to make bets on that process continuing. When the Asian Crisis and the Russian default occurred in the summer of 1998, their bets started to go against them and they were effectively out of business in three weeks. However, the Fed organized an orderly unwinding of their massive positions, while cutting interest rates sharply, permitting the investment banks to go back to their risk taking ways The culmination of this process of privatizing profits and socializing risks, was the plunge by the investment banks, as well as numerous commercial banks, savings and loans, foreign banks, hedge funds, and insurance companies, into the sub prime and non investment grade US mortgage market in 2004-07, believing that the bad credits underlying them could be sold on to others.