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GaveKal Ad Hoc Comment

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Hermes Ties, Longines Watches & Sub-Prime Bonds

I live in Asia. Consequently, I frequently find myself stopped in the middle of the street by a local "entrepreneur" who offers me a Hermes tie for US$5, or a Longines watch for US$10. I always walk away because, deep down, I suspect that there is something wrong and that the product on offer might not be the genuine article. I also imagine that I am not alone in making this assumption....

When I am not walking down the street, I am typically studying financial markets. And there, to my surprise, a lot of fake Hermes ties and Longines watches have been sold, as genuine articles, to customers that were either stupid, accomplices or both, in what might have been one of the greatest swindles of all time.

Let me explain: if instead of selling ties, my local entrepreneur had been trying to sell me a corporate bond, he would have approached me and said: "Look here; in my bag. Underneath the cabbage: I have a beautiful AAA bond, which yields 6.5% instead of 4.5%..." I would hope that my alarm bells would have gone off and that I would have suspected that something fishy was going on. In other words, as for the Hermes ties and the Longines watches, I would have assumed that these bonds were not the genuine article.

As a rule, when someone tries to sell me something with a totally abnormal profitability given the apparent risk, I become immediately suspicious. My suspicion turns into genuine panic if on top of it the seller is willing to "guarantee" either a return significantly above the government bond yield, or a return of my capital regardless of what has happened in the markets, at any time… So I knew that there was something wrong in the sub-prime market, but I had better things to do than to try to understand these very complex products (namely, make money the old fashioned way by buying equities, and holding on to them as if my life depended on it).

Having had the privilege of working in the financial markets for nearly four decades, I have seen all kind of bear markets. And I find that they typically fall in one of two categories:

- The bear markets created by governments, usually because one or several of what we have called *The Five Cardinal Sins* (protectionism, tax increases, monetary policy mistakes, regulatory overkill or war…) are committed. Japan in the 1990s comes to mind.
- The bear markets triggered by the market participants themselves, usually because of the belief in some kind of a "Ponzi scheme" (Ponzi was that ingenious investor who was guaranteeing a very high return and paid the returns to the old members by borrowing from the new members. As long as the entries are higher than the exits, the system grows, and then it collapses when it moves into negative cash flows….).

The current sub-prime debacle falls mostly into the second category of bear markets, though it was also partly a result of silly regulations imposed on pension funds, insurance companies and the like. In that respect, it resembles a lot the late 1990s-early 2000s bull-bear market which was in large part triggered by the push towards indexation (see *Killing the Wrong Pig*, *Indexation & Misallocation of Capital*, *Another Problem with Indexing*…). A phenomenon which, at the time, we equated to socialism (i.e.: the bigger a company is, the more capital it should get, regardless of its marginal returns on capital)… and, when you think of it, has there ever been a bigger Ponzi scheme than socialism?

1– The Typology of an Institutional Ponzi Scheme

A good Ponzi scheme always start with an "abnormally" high rate of return, "guaranteed" by a fairly respectable institution or individual. It also fulfills a need. With that framework in mind, let's review the current subprime debacle.

From 2000 to 2003, we had a huge bear market in equities (funnily enough, created by the previous Ponzi scheme called indexation… see all of our writings in late 1999 and 2000). As a result of the indexation craze, pension funds and insurance companies around the world found themselves under-capitalized. The regulators, always keen to close the barn's door once the horses had fled, then decided to prevent the under-capitalized institutions from buying anymore equities (see *Immunizing Liabilities? Don't!* & *Did Gordon Brown Kill the UK Pension Industry?*). This left pension funds and insurance companies with a crying need: how to replace equities, the high return part of their portfolios? Since, according to the new regulations, they could only buy bonds, they were forced, if they wanted to boost returns, to buy very low quality bonds, offering very high immediate returns (yields). The problem was of course that the regulators had told them that they could not buy bonds below "investment grade" (whatever that was)… and that as a result of the massive demand for yields around the world, the returns on investment grade bonds were far below the returns on equities that they now had to replace… So all of a sudden, here was a new need: **the low quality bond with a high rating.**

When someone offers me a US$5 Hermes tie, I suspect it is not real.

Now the beauty of capitalism is that a demand usually does not have to wait too long until a supply emerges. And if this is true of Main Street, it is true in spades for Wall Street! **If I have learn just one thing in my career, it is that Wall-Street will always find a way to satisfy a demand!** The supply of financial products will always rise to meet the demand and the elasticity of production on Wall-Street is, I believe, infinite… In the late 1990s, (the indexation bull-bear market), the work-load fell on consultants and indexers. This time, it fell on the rating agencies and the houses specialized on the financing of houses (derivative products.). As a result of this new demand, the wizards on Wall-Street started to work feverishly.

And when someone offers me a AA bond whose yield is completely out of whack with similar issue, I also suspect something is fishy.

2– Putting Together the US$5 Hermes Tie

In my previous life as a money manager, one of my business partner would always say: "I have never met a simulation I did not like". And sure enough, the mathematical geniuses in charge of building the new product "designed" portfolios of mortgages, mixing them in a way that, in the past would have guaranteed the high returns needed, and the repayment of the principal at the end. The fact that the historical sample on which they built their computations had nothing to do with the current issues was of course never discussed.

The rating agencies, impressed by the soundness of the computation, and even more by the huge fees that they were getting for rating these (toxic) products, started to deliver "investment grade" ratings to products that had never met a (free) market, not paying enough attention perhaps to the slight conflict of interest that they could have. And before you knew it, the problem was solved: we had at last a junk bond with a AAA rating…

3– The Returns of the Capitalist System

Once again, it seems that everything started with a regulatory or political intervention, forcing a change in the asset or liability side of the balance sheets of financial institutions, without changing the other side. Preventing insurance companies or pension funds from buying equities at the bottom of a bear market was a mistake of massive proportions. This decision reduced the future returns, without reducing the future costs (which are of course a function of past contracts, signed way before the interdiction).

The sub-prime debacle is a direct result of the constraints that were put on pension funds and insurance companies.

Unfortunately, most politicians seem to want to deal with the debacle by imposing yet more constraints! Meanwhile, the answer is obviously to let the market do its job.

If there is a danger to the sub-prime debacle, it lies in the political response.

The reality of the capitalistic system is, however, fairly easy for all to see (we have written on this extensively in *Rentiers vs Entrepreneurs*, *Des Lions Menes Par des Anes*, etc…). Basically, the capitalistic system offers returns spread around three anchors (for a diversified portfolio).

- 1% real, for those who cannot afford any kind of volatility. They have to buy 3 months T-bills, in their own currency.
- 3% real, for those willing to take a duration risk, but no risk on the return *of* capital. They have to buy long dated government bonds.
- 6% real, for those willing to forfeit for ever the reimbursement of their capital (no guaranteed return *of* capital or *on* capital), and are willing to take the equity risk. These people have, over time, a much higher return on capital.

4– So What Happened?

Let us imagine an insurance company which signed contracts based on expectations of 4.5% real returns. It will, logically, have invested 50% in equities and 50% in long dated bonds. Now let us imagine that, suddenly the regulator comes in and tells our insurance company not to own any, or at least much less, equity. Our insurance company will thus have to either:

a) Move up the risk scale in the bond market considerably (replacing the volatility risk of equities with the default risk of junk bonds - far worse in my humble opinion) or,

b) Move up the duration scale considerably and cross its fingers that it's duration bet (at a time of very low rates) pays off (see *Of Bonds and Zombies*).

Either way, the financial system moved in fairly quickly to satisfy the new demand and returns were abnormally high in this new and very profitable activity while the new demand was being serviced. Unfortunately, however, at some point reality always sets in and Ponzi goes to jail. The lawyers then come in and it is their turn to start making real money… Obviously, in the US today, and as far as the sub prime market concerned, we are entering the "lawyers phase".

5– But Is it All Bad News?

Usually, just thinking of lawyers is enough to make me break out in a cold sweat (and I've never even been involved in any litigious activity in my life!) but try as I may, I have a hard time seeing the current sub-prime debacle as the ominous signs of a forthcoming implosion in the US, and global, equity markets. In fact, one could conclude that the sub-prime debacle is great news for the equity markets; after all, our Ponzi scheme, which, for the past few years had been the only competition in town to stocks and commodities, is now disappearing. Should we be surprised that, as the Ponzi-scheme competition disappears, equities in the US and around the world, along with commodities, are making new highs?

This, of course, leaves us with another question: how many Ponzi schemes will we need to live through before regulators and politicians stop intervening in financial markets and institutions to "improve" the situation? On this one, there are undeniably more cause for concerns. After all, few politicians in the US today seem to have the wisdom of Lord Salisbury who, when invited by Queen Victoria to institute various changes replied: "Change, Your Majesty, change? Don't you think that things are bad enough as they are?". Unfortunately, it seems that, today, they are few Lord Salisbury in the halls of power in Washington DC. So if you are of a worrying disposition, this is where I would look for the bad news… And for those of us with an optimistic outlook on life, maybe the Ron Paul candidacy starts to pick up some traction...