STEPPING STONES MANAGEMENT, LLC

Third Quarter 2008 Commentary

October 13, 2008

The third quarter of 2008 was the most historic period in our financial markets since the early 1930s and will result in radical changes to the way our financial system functions. In trying to explain the quarter, let me begin with a passage I received that sets the table nicely:

> A family would borrow $100,000 from Countrywide, which would sell $100,000 of bonds to hedge funds, which would borrow $100,000 from Bear Stearns, their prime broker, to buy these bonds. Bear would raise this money by selling $100,000 of commercial paper to Lehman Brothers, which would then borrow $100,000 through the inter-bank market from Bank of America. The original borrower is still the same household and the ultimate lender is still BofA, but now a $100,000 mortgage has created $500,000 of new debts. – *GaveKal*

It not only sums up how financial institutions are dependent on each other but also how debt is magnified as it is intermediated. Because of this financial intermediation, that family can borrow that money to buy that house and financial institutions can relend the same capital that initially enabled them to write that mortgage and thus more families will be able to get mortgage financing and become homeowners. So far this is all good as our society has deemed through our political structures that home ownership is good for society. The problem arose because mortgages were written to unqualified borrowers and performed well as long as home prices were rising.

The mortgages continued to be written because there were investors who wanted to buy this paper in order to receive returns in excess of what they could get in the Treasury market. The biggest of these investors was Fannie Mae, the government sponsored enterprise set up to foster home ownership. Fannie Mae and its sister corporation Freddie Mac were able to borrow money in the credit market at rates almost as low as Treasury rates because they were "implicitly" guaranteed by the government; that guarantee became explicit on September 7th. Fannie Mae would take that low interest money and buy higher interest loans and make money off of the spread. The more loans they carried on their books, the more money they made and the higher their mangers' bonuses became. Hedge funds saw a way to do the same thing by borrowing yen at even lower Japanese rates, converting to dollars, and buying similar mortgages. Everything worked fine as long as home prices kept rising enabling strained borrowers to refinance. However, there are a finite number of people qualified to buy homes and that number was reached and exceeded before the demand for this paper was satiated. After all the prime borrowers had homes, lenders looked to sub-prime borrowers, spurred on by government pressure to lend to people who normally couldn't get loans. These subprime and near prime loans comprised 9% of mortgages in 2001 and grew to 40% in 2006. In order to make this sub-prime paper attractive to investors who only wanted prime paper, financial firms would slice the mortgages into tranches where the lowest amount of principle and interest would get prime ratings and the higher amounts would be subprime. So a $500,000 mortgage on a home that was foreclosed and sold for $250,000 would pay off the prime slices but not the subprime ones. These slices were run though various layers of intermediation such as a Real Estate Mortgage Investment Conduit (REMIC) Trust slicing the loans and creating Residential Mortgage Backed Securities (RMBS) which would be further sliced and sold to various Collateralized Debt Obligations (CDO) which would be bought by other CDOs (CDO Squared) and bank sponsored Structured Investment Vehicles (SIV) which would be funded by selling short term commercial paper. At every step of the way, financial managers earned fees for performing their alchemy. That last point goes a long way to explain why the financial firms were so excited about these subprime loans. In order to sell these highly complex products, the financial firms relied on ratings agencies like S&P and Moody's to grant ratings that would induce the buyers to buy. The ratings agencies welcomed the business of analyzing and granting ratings, for a fee. Risk management departments at these financial firms had very esoteric models that could accurately predict the risk of these complex vehicles and financial firms could even write insurance based on these models and the rating's firms opinions. One of the big problems was that the risk models didn't factor that home prices could decline by over 20% nationally, which has happened.

I hope I haven't made it too complex but that is the point. The institutional buyers of these products had no way of seeing what all the slices in their CDO or SIV really were, thus the reliance on the ratings. When home prices fell beyond the risk models' ranges, the products did not perform as well as they were supposed to. This brings us to Fair Value Accounting standards which came into vogue after the Japanese banking crisis of the 1990s. Fair Value Accounting makes financial firms carry their assets on their balance sheets not at cost but at fair value so that investors in these firms have a real view as to what the companies are worth. Japan did not do this and they experienced a decade with zombie banks that everyone knew were not as valuable as stated and therefore people didn't do business with them. There are two ways to determine fair value. In business school they taught me to arrive at this number by discounting the present value of all the expected income streams over the life of the investment. If those income streams diminish, the present value is reduced accordingly. Another way is by assigning the value that the asset could be sold for today. The former is subject to the assessor's view of interest rates and their opinion as to what the income stream will be over that life, the latter removes that subjectivity. The latter is called "mark to market" and these rules have been furthered over many years but became far more stringent last November with accounting rule FAS 157. The problem is that when investors realized that the ratings agencies got it wrong and a given CDO wasn't really as valuable as thought, they couldn't assess that value for themselves because of the complexity and opaqueness of the products. A year ago I wrote that when buyers don't trust what they are buying, they don't buy. Therefore there was no market to mark against.

This brings us to Level III assets which are those that can't be marked against an active market so accountants are required to use some other market "inputs" of similar securities. In this case the ABX index of subprime loans was used. The index was developed in 2006 and has been used to provide a benchmark which derivative securities could be based on. When investors began to see home prices turn down in 2006 they bet on this index falling and bought derivative securities which would benefit from such a move. This happened to such a large extent that it became a self fulfilling prophecy and the index gave a value of zero on the subprime slices and 50 cents on the dollar to the prime slices. Many people, including me, maintain that this was not a reflection of these securities' fair value. However rules are rules so the financial firms holding these products had to mark them down accordingly. This is a big problem when the typical Wall Street firm is leveraged 30 times which means they hold 30 times more assets than their companies are worth, the other 29 being made up with debt to buy those assets. The assets go down in value but the debt burden doesn't and the equity of the firms get wiped out even though there may not be a cash flow problem. If current mark to market accounting rules were in place during the Latin America debt crisis of the early 80s, all of our money center banks would have been closed.

Much of the debt used to buy those assets was in the form of short term commercial paper, refer to the step of Bear Stearns getting money from Lehman Brothers in the quote atop page one. In the Bear Stearns case, the company sponsored some hedge funds that invested in these CDOs and they had trouble rolling their commercial paper in July 2007. Because they borrowed short term to buy long term assets, the funds collapsed and Bear Stearns had to absorb those assets onto its balance sheet. That was the beginning of the financial crisis and the Federal Reserve came to the rescue by injecting liquidity into the banking system so losses from such products could be absorbed and traders at financial firms could trust their counterparties to settle their trades. However these products continued to strain the capital on the balance sheets of financial firms who created more than they could sell to Fannie Mae and the hedge funds. This is where the bear raiders come in. In the summer of 2007 the Securities and Exchange Commission abolished the uptick rule thus enabling short sellers to sell into a falling market. This had not been possible since the bear raids of the Great Depression. Bear Stearns was the first target and in the course of a week in March the company found they couldn't raise day to day capital in the interdealer network due to their stock plummeting and their credit default swaps (basically bond insurance that lenders purchase to hedge their loans) rising to the point that lenders couldn't trust their ability to repay. Fearing a breakdown of the system explained in the paragraph on page one, the Fed and Treasury arranged the buyout with JP Morgan on St. Patrick's Day. The SEC then instituted temporary rules restricting naked short selling (which were really just enhanced enforcement guidelines of existing rules). Things seemed fine until July when those temporary rules expired. Then Lehman Brothers became the target, and then AIG and Merrill Lynch. Around this time, the enormous internal loan portfolios at Fannie Mae and Freddie Mac became suspect and buyers of their bonds refused to buy anymore. Since they also borrowed short to lend long, the government had to step in and make the implicit guarantee explicit. The crisis was fully aflame. The most dangerous point to the economy came on September 18, the day after a large money market fund “broke the buck”. That means its net asset value fell below the standard $1 per share. Money market funds are simply bond mutual funds comprised of high quality very short term notes. In this case, some of the fund’s notes were issued by Lehman Brothers and AIG and were not paid when they came due. Money market funds currently hold over $3 trillion and on that Thursday morning many people were cashing out those funds and buying Treasury notes and gold. This was the modern day run on the banks but it happened over a course of hours rather than months, prompting the Treasury Department to guarantee all money market funds. When money market funds are redeemed, the fund doesn’t roll some of the notes so the issuers of those notes can’t get the financing they need for day to day operations and have to come up with the cash to pay back the notes. Even highly rated companies such as Goldman Sachs and General Electric who supposedly didn’t play in the subprime mortgage game were forced to turn to Warren Buffet for financing. Good thing for them, he obliged.

There is obviously much more to the story than can be told in this letter of limited length, of course including the stock market crash that has occurred so far this October. One of the market fears now is what happens to the huge market of credit default swaps which nobody really knows how to assess. This is the bond insurance which is often held by parties that don’t have the bonds to insure but see it as a vehicle to bet on a company’s viability or lack thereof. These are individual contracts made between parties with no central market place to report prices and volumes. Another worry is one I have continuously written about over the past year, the national employment scenario. If regular folks begin to lose their jobs because their companies’ can’t get financing then what happens further to housing and the rest of the consumer driven economy? I don’t think we will be out of the woods until housing begins to stabilize and a weakening employment picture impedes that stabilization. However, some hopeful signs have emerged in housing where rates of decline in house prices are lessening (although still declining) and housing futures prices (yes they even have derivatives on that) predict a rise in late 2009 to 2010. Other hopeful signals are the sharp drops in commodity prices across the food and energy spectrum which will benefit corporate America as well as Americans themselves. Now we will realize why the consumer price index is also reported excluding food and energy as the headline number will surely show a drop in inflation driven by those declines. Hope also comes from corporate earnings which are not freefalling like stock prices. Although future earnings are likely to be lower due to this crisis, stock prices have come off a period of historic underperformance as opposed to historic outperformance which typically precedes such drops like we’ve had. This suggests that things are not as bad as the markets are discounting and we have not sold into the fall. I take great comfort from the rally in the US Dollar that has risen above the levels it fell below in the spring of 2007. This may be more a commentary on the rest of the world than on the US economy though; the saying goes when the US sneezes the rest of the world gets a cold. I don't want to sound Pollyannaish but I believe in this country and I believe that corporate America will continue to serve the burgeoning middle class across the world. Yes, our financial system is in tatters because the people who run it let it get away from them. However, hundreds of millions of American continue to go to work each day and do their jobs satisfying the needs of others and the same thing is replicated to a growing extent throughout the world. Satisfying the needs of others is the most basic element of an economy and our political and financial "leaders" can't take that away from us.

As we pick up the pieces after the worst week in stock market history I will be looking at a few specific areas to try to get a handle on where things stand. Of course housing and employment are two very important topics of the crisis currently. I will also be looking at the extremely opaque market for credit default swaps, which is giving me the most indigestion because I can't assess it. I am also looking at the broader topic of the great deleveraging and how far along we are in it. I wrote in an e-mail a while back that if you think the stock market is based on leveraged hedge funds playing with borrowed money then you should sell. If on the other hand, you think the stock market is based on investors wanting to participate in businesses offering needed products and services to growing markets then you should buy. I still fall in the latter camp even after the last fifteen months that seem to prove the former. I continue to appreciate your perseverance through this lost decade of stock market investing and as always I thank you for your trust and thank you for your business.

Yours truly,

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