STEPPING STONES MANAGEMENT, LLC

Anatomy of a 21st Century Bear Raid

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If you knew a drunk who likes to ride his motorcycle to and from the bar with no helmet, you might want to buy some insurance on his life. Unless you were reliant on him living, you could not because you would not have an "insurable interest". However, if you came across a company with questionable assets on its balance sheet that needs to raise money in the short term commercial paper market to fund regular operations, you could buy insurance to protect against that company defaulting on its debt; even if you didn't have an insurable interest by owning any of that debt. This insurance is called a credit default swap and I'm sure you have seen that term in the news quite a bit this week. Like any product, a credit default swap is subject to the laws of supply and demand so when that demand increases so does the price.

When giant hedge funds want to take advantage of the 2007 repeal of the uptick rule, which was put in place during the Great Depression to prevent bear raids, they not only sell a company's stock short, they also buy the credit default swaps and drive up the price of that insurance. If you are a financial company fighting off a bear raid and you see your capital position deteriorating due to mark to market accounting rules, forcing you to write down assets that you have no intention of selling, you are faced with two choices. One is to sell some stock which would be very dilutive after your stock has sustained a 90% haircut (if you could even find a buyer). Another would be to borrow the money you need until the storm passes. Any financial institution that would make that loan would also hedge their exposure with a credit default swap and factor the price of that insurance into the rate they would charge you. The rate would be prohibitively high since the players with no insurable interest have bid the price of that insurance up like a 1990s dot com stock. Last week, Lehman Brothers found they couldn't attract an equity investment and they couldn't afford to borrow because their credit default swaps were too expensive. Bankruptcy was the only option and the bear raiders won that fight and then moved onto Merrill Lynch, AIG, and others. The Wall Street Journal compared it to hyenas attacking sickly wildebeests.

I'm sure we all agree that our financial markets would better off if they did not resemble the African Plain and fingers are pointing in all directions as to how we got to this point. Blame is directed at wrongheaded government policies promulgated from both sides of the political aisle, regulators who didn't understand the markets they were regulating, corporate executives who didn't understand the toxicity of the financial products they were producing, and ratings agencies and insurers who didn't understand the risks they were assessing. All of these players are invested with a public trust to not make these errors and they all failed. As a result, the giant hedge funds whose only purpose is to maximize financial returns took advantage of all the fault lines and made a killing, or several killings.

Much has been written about this episode and much more will be; I'd be happy to discuss it further with you at any time. The question is where do we stand now and I'd be lying if I said I know. What strikes me is that the general market has held up as well as it has in such an historic financial crisis. I think that's because corporate balance sheets, outside of financial companies, are in very good shape and the sharp drops we are seeing in commodity prices will bolster their income statements too. We will soon find out how much Main Street needs Wall Street, let's hope not too much.

Yours truly,

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