Henry Waxman, Hedge Fund Managers and 'Mr. Market Miscalculates'

by Kirk W. Tofte
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On October 13, 2008 the heads of our nation's five largest hedge funds were summoned before a U.S. House committee headed by the inimitable Henry Waxman. Although it initially appeared to be a "show trial" in an almost Soviet sense of the term, the hearing surprisingly turned into a rather informative affair.

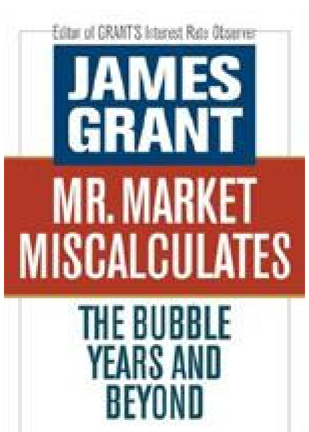
A congressman asked each of the hedge fund managers how their investment portfolios could have thrived when most financial markets have been in total disarray. One of the managers replied that he had shorted subprime mortgage-backed securities after researching their underlying assets diligently for months. His firm found that most of the mortgages were issued with no down payments having been made, to parties with bad credit histories and with virtually no documentation provided (because none was required) to the lender. Their conclusion was that most if not all of the mortgages would go into default, despite the fact that "independent" rating agencies had deemed as being investment grade – even declaring them AAA-rated in some instances – the securities behind which these same mortgages stood as collateral.

Unlike investment banks, credit rating agencies and – now – Henry Paulson, this hedge fund manager obviously did his homework. We can do a little of the same for ourselves in order to come to grips with the financial mess that has resulted by reading James Grant's new book, *Mr. Market Miscalculates.*

After having read the book twice during the past four days, I can say without equivocation that it is a must-read item. Grant lays out on the table almost all of the key pieces involved in the current credit crisis that is enveloping the world, even though the last essay was written late this spring. Fortunately, James Grant gives us most of the last pieces of the puzzle in his op-ed, *The Confidence Game*, which was published in the *Wall Street Journal* on October 18, 2008. It, too, must be read in its entirety to be fully appreciated.

Grant's basic arguments involve the insight that interest rate cycles in the United States take generations to complete and that we have now reached the end of one of the greatest bull markets in debt securities of all kinds that his country has ever seen. In his opinion, interest rates can only go up from here over the next couple of decades.

But it is the transition from falling interest rates to rising ones that is shaking the foundations of the credit markets currently. For odd and various historical reasons, since the early 1980s Americans have seen the government, corporate and private debt that they have incurred over the past twenty-five years lapped up in world markets at ever lower interest rates and on increasingly better borrowing terms for the debtors.



At times this free flow of credit extended to the United States from around the world has seemed indiscriminate. In Grant's view, this lack of discrimination was most obvious at the tail end of the bull market in debt securities he has been watching with a gimlet eye for over twenty-five years. How else could one explain, he asks, the fact that until at least halfway through 2007 securitized debt derived from subprime home mortgages originated in the United States could be priced to yield very little more than Treasury issues with comparable implied maturity dates? How, indeed! In his recent Wall Street Journal article, Grant comes very close to providing us with the answer to his own query.

American debt originated from a known source in this country – everywhere. But from where was all the credit derived? Increasingly in recent years, it has come from foreign countries and, especially, from emerging-market nations in Asia and elsewhere.

Private exporters in these foreign countries would take the dollars they obtained through the trading of their goods sold in the United States to their respective central banks and have the dollars redeemed for local currencies. Since many more exports went to the United States than did imports from America go to these countries, certain foreign central banks accumulated huge surpluses of our currencies. Rather than hold non-interest bearing dollars, these foreign central banks purchased debt securities issued by American entities of virtually all types.

As Grant puts it, "Our foreign creditors accepted dollars in payment for their goods and services – and then obligingly invested the same dollars in America's own securities. It's as if the money never left the 50 states." But it is important to note that most of these securities were of the debt variety. And the central banks of emerging market countries may not have been as indiscriminate in their purchases of this debt as it might first have appeared.

The safest debt that foreigners can buy is that issued directly by the U.S. Treasury. As worldwide demand for this debt increased and yields dropped, foreign creditors would naturally have looked – as they did – to debt issued by government sponsored entities (e.g., Fannie Mae and Freddie Mac) for its higher yields and implied U.S. Treasury backing. Finally, these conservative debt investors began to consider the purchase of investment-grade debt, particularly AAA-rated securities.

Due to America's trade imbalances with the rest of the world, the demand for all three kinds of debt (treasuries, GSE-related and investment-grade securitized obligations) soared. Wall Street was more than happy to try to meet this demand and did so until it got to the point of creating "mortgage contraptions so complex as to baffle even the people who invented them."

Unfortunately, these "contraptions" gave new and dire meanings to the phrase "the alchemy of finance" pioneered by George Soros many years ago. The conjurer's trick in this case was to turn debt that was decidedly not investment-grade (i.e., subprime mortgages or, as Grant calls them, "junk mortgages") into AAA-rated securities. Wall Street was only able to apparently do so by plugging optimistic assumptions into complex computer models and then selling the conclusions spit out as justifications for AAA investment ratings provided for them by compliant rating agencies – all for big fees, commissions and underwriting profits, of course.

As Wall Street continued to push the envelope, additional assurances of the soundness of these collateralized mortgage obligations (CDOs) began to be demanded by creditors. Synthetic CDOs were created to add "insurance" in the form of credit default swaps and the band played on for a little while longer.

But then the music stopped when subprime mortgages began to default and all the participants in the game realized that there were not enough safe seats for each of them to sit in. At this point, the Federal Reserve and the United States Treasury intervened. First they secured Fannie Mae and Freddie Mac by taking over ownership of them. Then they purchased eighty percent of AIG, the largest issuer of credit default swaps in the world. Finally, the U.S. Treasury has begun the process of injecting $350 billion to $700 billion into the capital structures of America's largest financial institutions.

You can read all about the folly in *Mr. Market Miscalculates* and you should probably weep while doing so. But James Grant writes too well, thinks too clearly and is just too darn funny to distract one from the narratives that make this book worth every penny it might cost you to purchase it.

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