



## Holland Views

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# It wasn't different this time

Much is made of the once-in-a-generation situation we now find ourselves in, but I would say that the more we study past bubbles, the more normal this one looks. Moreover, not only was the existence of the bubble accurately predicted, but so were many of the specific failures – if only we had asked the right people.

I have re-read a few investment classics by Buffett, Graham, Schiller and co recently. Whilst doing so, I have been staggered by the high degree of relevance of what was written 20, 40 or 70 years ago to the investment outlook that faces us today. I also confess to having learnt an embarrassingly large amount about an industry in which I professed to be an expert.

Many busy investors will stop reading this piece now, considering it to be “theory” and “not relevant” to the issues they face today. I encourage you not to. I do not consider this hindsight, or indulgence but believe there are important lessons to learn and clues as to what might fail next.

## Extremism failed

This may seem a strange generalisation, but I think it correct to observe the following examples of extremist approach that failed:

- Momentum investors performed poorly
- Value investors (often ignoring macro trends) performed poorly too
- Traditional economic forecasting failed
- Free market extremist beliefs were proved wrong
- Greater reliance on asset-backed borrowing was flawed

Promoters of each relied on extrapolating recent history to ‘prove’ their arguments. The longer each theory worked, the greater the conviction became that it would continue to do so. Those who succeeded in either predicting recent economic events or investing wisely throughout them were not extremists. As investors, they were likely fundamentally driven but with an eye to the macro risks. The successful economists were not those who relied on computer models but those who realised the important roles that human behaviour and psychology play in economics and markets.

Hyman Minsky was one such person, predicting the events of the last 3 years, despite them occurring some 11 years after his death. [See a great article on the relevance of his work today by Pimco’s Paul McCulley – May 2009]. Unlike Minsky, Robert Schiller is alive to receive his plaudits for predicting much of the asset price collapses of recent years. I was lucky enough to attend a speech by him last month when he said: “After this (i.e. the crunch), economic thinking must now change” and “it must adopt the use of human psychology”. I have always felt that too many macro forecasters in New York or London Ivory towers missed this point. Many still do.

## Eerie lessons in leverage - Who failed, why and who is next?

Let's look at some specific examples of what went wrong, whether we could have predicted it and what type of business could still fail. In doing this, I will refer to a few lessons laid out for us by old men and old books and show their relevance to today.

### Lehmans/Investment banking

In the wonderful 1990 book *Margin of Safety*, Seth Klarman observed the following about investment fads and, in particular, the 1980s junk bond era:

- “Wall Street gets paid for what it does, not how well it does it”
- “In virtually all financial innovations and fads, Wall Street creates additional supply until it equals and exceeds market demand” for the new product.
- “one of the last junk bond innovations was a Collateralised Bond Obligation (CBO)”
- “What attracted investors to the CBOs was the rating agencies giving about 75% of a junk bond issue an investment-grade rating”

I read this last year during the sub-prime loans fallout and was staggered by the remarkable similarity between junk bonds and sub-prime loans – whether in the demand for them, their supply, the credit agency approval or even their abbreviations (CDOs vs. CBOs!). Even though Klarman was clearly dismayed by the junk bond debacle, he observed:

*“We may confidently expect there will be new investment fads in the future. They too will expand beyond the rational limits of innovation. As surely as this will happen no bell will toll to announce the excess.”*

I remind you that this was written in 1990, not 2007, nor so long ago that there should not be plenty of experience around to warn of repeating such mistakes. Were there those who warned of this crisis? Of course there were, and they all had one thing in common – the grey hair that comes with seeing episodes like junk bonds come and go. Stand up Jim Grant and take your bow.

### Investing in High Yield

In Ben Graham's classic, *Security Analysis* 1940(SA), we were told: “High-yield bonds should only be bought at a discount to par value; i.e. they are the bonds of a company that may have been good quality but had fallen on hard times.” He also put it another way: “It is one thing to buy fallen angels, it is quite another to buy those who have never taken wing.” Such a simple rule, had we ever bothered to read it, would have kept us out of sub-prime, CDOs, MBS+RMBS and a lot of trouble.

### Some Investors read and remember it seems?

*Security Analysis* (1940) also gave guidance for investing in bonds that come with free options to buy the issuers' shares. It suggested we consider:

- How big is the option per \$ of bond invested
- How close to the current price is that option (conversion premium)
- For how many years does the option to buy last for?

Imagine today you were offered a 10% coupon on an investment-grade company from an entity with a fantastic track record and a leader in its industry (i.e. a fallen angel). In addition, you were given \$1 worth of options on the company's shares for each \$1 of

money you have lent them, and that these options were exercisable at today's share price for the next 10 years. Would that excite you? It should, as it gives you so many options to make an even greater return than the already high 10% coupon you are going to receive. Not only is this lifted from the 1940's text book, it also almost perfectly describes Buffet's investments over the last year in Goldman, GE and Harley Davidson, investments that were often criticised in the months following.

### Securitisation - Some uncanny revaluations from the past

Again we refer to Security Analysis (SA), "*the bulk of fixed-interest analysis should be on the entities' ability to service the bonds outstanding rather than just focusing on the collateral behind them*". This sentence alone makes many of the debt innovations in the last 10 years look questionable. That aside, the book gave some interesting exceptions to this rule where extra security can be gained from a "securitised movable asset" which is being lent against. Three examples were given, two were:

- "Rail rolling stock secured loans"
- "Investment Trust lending"

In both cases, SA informs us that the lender has double security as the borrowing entity guarantees the loan, but also, in default, he has a charge over the asset. The securitisation junkies among my readers, last count none, will be both bored of my Ladybird book description of their art and jumping for joy as they claim: "See. We told you this was proper lending, we were just unlucky." Not so fast. Graham emphasises the words "movable" when he talks about assets to securitise. He goes on to state that a similar argument "cannot" be made for a single-use premises "like a factory, garage hospital, factory or a hotel". I might add 'or a pub'.

### **Is all this relevant? - Oh Yes.**

No less than 70 years ago, in 5 or 6 pages of text, we were given a simple but still incredibly accurate assessment of what is the right and wrong way to analyse a loan and what are the right and wrong assets to securitise. Graham in 1940 understood what few investors did in 2006: i.e. that the double security of company guarantees and asset backing is worth little if there is no alternative use for the asset. In my opinion, this provides quite considerable clarity on the following issues:

- The pub securitisation steamroller showed itself to be fallible at the point at which assets could not be sold as they had no alternative use and could not be moved
- Despite its spectacular (equity) collapse in 1992, GPA, a huge aircraft leasing business, did not default on its loans. The planes were moved and sold
- UK railway rolling stock lenders have not suffered in this downturn
- Why securitisation of buses, as yet untried, could work
- Why plant companies like Speedy Hire or Ashtead, which have recently sold plant to the Far East, may be more resilient than more heavy asset-reliant businesses
- How commercial property sites in out-of-town retail parks could create white elephants
- Why the global securitised and leveraged hotel sector scares me rigid
- Why despite reading now and again about investors losing 70% of their capital when an investment fund closes, banks lending to them rarely report losses from the event

### What Ben Graham said about Mortgages

In his writing on securitisation, he suggested three asset classes where extra security could be found. The third was: “residential secured loans” (i.e. housing).

When, in 2009, you read this asset class as having ‘good security’, you cannot help but think the 1940’s analysis is a little dated. A few more pages on, you realise that you are at fault, not the text. It argues that as a house can be let to multiple renters, it more versatile and therefore better collateral than a factory, which has a sole use. Importantly, it makes further observations:

- “The amount of the loan should not be over 66% of the value of the property”
- “That that property value is fair, not reflecting speculative information and does not greatly exceed the price levels existing for a long period previously”
- The value “should not be based on excessive construction cost or abnormal rental values”
- Abnormal rentals are due to “premiums paid for new properties which will then reduce” or “higher demand for rentals will create supply” returning rentals to earlier levels.
- “Lenders should minimise the risk of large loss due to change in the neighborhood”, i.e. local oversupply

I remind you again that these are quotes from 1940. Uncanny is it not how these points describe the pitfalls that were the US and Anglo Saxon housing bubble. So, the shortcut to all these rules on securitisation is that it either must be movable or be a house that is prudently valued and not in an area of oversupply. It is clear that much of Wall Street loved securitisation and, as Klarman predicted, grew capacity infinitely to match any demand. What is also clear is that few investors knew the important caveats we have outlined which were made many years before.

### I’d rather have a caravan

In parts of the US where residential prices have now fallen to a point where realistic rental rates produce a good yield on today’s lower selling prices and where overcapacity is not a problem, opportunity may now lie. I believe that UK housing values are still a long way from such underlying support, however. Sadly, I have yet to see a buy-to-let flat being moved in location either!

### Bank failures plenty

Earlier, we have shed a little light on why investment banks failed. In addition, much has been written about the failures of Northern Rock and HBOS due to their over-reliance on wholesale lending markets but we should also remember that N.Rock fell foul of another sacred rule which Buffet has often quoted. He observed that banks should never be run to a targeted level of earnings growth. The reason being was that such targets committed it to lending, i.e. to take in spread (profit), whether the risk of losses was high or not. Simple stuff really, but any investor who looked at N.Rock while it was still breathing will be familiar with the company’s absolute determination to grow assets and profits at considerable rates every year.

Anglo Irish bank also fell foul of this rule in addition to relying on wholesale funding. Had both banks survived a little longer, we may have also seen how their models broke Graham rules on securitisation too:

- Do not lend against single-use business premises – Anglo Irish
- Do not lend against inflated housing values – Northern Rock

### [The madness that was convertible arbitrage](#)

Graham observed that “No more than 25-30% of a convertible value should be derived from the equity component”. He went on “In 1925-1929, convertibles were in vogue with poorer quality companies using them while better quality ones raised capital via the bond markets”. The boom in convertible bonds in 2000-2007 looks pretty much an exact replica of this. Clever financiers believed they had yet again reinvented the wheel. We were told “greater stock volatility justified greater equity components”, hence the lower coupon rates paid by some high-risk companies. In the recent convertible bubble, the phrase “Delta Hedge” was invented. Investors in 1929 did not name their desire for weird finance but they also liked this “new” idea. They could see smaller companies’ shares rising faster than big ones and this meant they would make more. Greed was common in both cases.

### [Macquarie and Me](#)

I wrote a short note on Copenhagen Airport in 2001, which was then on a low valuation and had new capacity allowing far greater future passenger throughput at little extra cost. I suggested the assets were high quality and that cash flow would exceed profits for quite a while due to the new capacity. During the stock market TMT phase it, like other real assets, was overlooked, along with my note. Two years later, a small Australian bank snapped up my little gem. It was opportunist and right that the quality of this and so many other predictable assets, could be borrowed against. Were Macquarie a private equity fund that closed down five years later selling assets for sizable profits, many seasoned investors might today have great respect for its innovation. This was clearly not the case and what started as investment opportunism became a steamroller. The age and experience of those doing deals plummeted along with the quality of the assets being securitised. At the same time, the leverage multiples increased and no one cared what lessons could be learned from 70-year-old books. The rest, as they say, is history.

## **What really went wrong - Nothing**

Articles abound suggesting that speculators, bankers or regulators were at fault for past excesses. While there are many such examples at the collective level, I offer a simpler solution to what went wrong. Nothing. Nothing went wrong at all. Investors, consumers and managers all collectively acted in a way that Minsky and Schiller expected us to. Humans are prone to greed, a herd mentality and are not interested in learning from wise old heads. As such, we as a race have performed pretty much as expected. As professions, both the banking and investment industries have failed yet again to learn from the past mistakes of others, which arguably suggests that neither is a “profession” at all. History may therefore judge recent events as unexceptional and, as Klarman observed, “we will likely do it again” one day.

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