Intelligence Security Diary

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Open Source Intelligence

Reprinted: Folio – Leverage
"Stalingrad Revisited"

The Folio in the May edition of the Diary discussed the excessive leverage being carried on in the United States financial system. Unfortunately, our worst expectations have materialized with the sub-prime mortgage implosion. Several of our readers have asked for a "reprint" of the May Folio and thus the attached "Stalingrad Revisited" article which deals with Wall Street's leverage. The regular August issue of the Diary will deal with the current situation in the capital markets in the context of economic intelligence and its growing importance in the realm of overall intelligence analysis.

Bad mortgage paper is proving more lethal than North Korean and Iranian nuclear weapons!

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OPEN SOURCE INTELLIGENCE

FOLIO – LEVERAGE “STALINGRAD REVISITED”

(reprinted from Diary May 2007 edition)

“Leverage – the magical power that allows investors to make big investments without putting big money on the table.”

Webster’s New World Dictionary defines ‘leverage’ as the “increased means of accomplishing some purpose”. The definition is imprecise and euphemistic – leverage prevails in many scenarios. When Hitler sent Field Marshall Friedrich von Paulus and the German Sixth Army into Stalingrad it was to extend the rapid invasion of the Soviet Union to even greater territorial gain. The German supply lines were extended, the brutal Russian winter was approaching and the Sixth Army was simply too fatigued from the pace-of-advance. It went down to defeat and brutal captivity. In the world of intelligence an overly extended and leveraged network of spy cells can lead to its demise. In the capital markets it is used to describe the use of debt to finance the aggressive expansion of operations to enhance returns on equity investment.

The Federal Reserve, Securities Exchange Commission and European regulators have spent recent months collecting information to determine the nature of the leverage and collateral arrangements with hedge funds. No one knows how much leverage is in existence! On March 27th, regulators held a conference call with bankers from nine Wall Street firms to brief them on their findings. The regulators informed the investment dealers of the following:

- Collateral arrangements are too weak for the amount of debt outstanding.
- Wall Street firms don’t have enough information from their hedge fund clients to assess risk.
- Contingency plans and arrangements have to be developed to deal with financial losses arising from the collapse of one or several large hedge funds.
- The regulators want to make sure U.S. banks can manage the dislocation emanating from a big hedge fund failure.

When markets turn negative, the bearish impact of leverage will increase exponentially. Bankers and derivatives dealers demand more collateral to cover losses. Investors sell stocks and bonds to raise cash – prices drop, further accelerating losses, and even more vicious selling ensues. Wall Street describes this potential scenario as the “The Great Unwind”.

Historical Precedence

In 1998, the highly leveraged hedge fund giant Long-Term Capital Management threatened to unleash the “Great Unwind” but a group of Wall Street firms under the direction of the Federal Reserve intervened to prevent a massive sell-off. In 2006 when the leveraged energy bets of Amaranth LLC went offside, the hedge fund suffered losses of approximately $6 billion. The market survived both situations with minimal adverse consequences. Burton Malkiel, a professor of economics at Princeton University and the author of *A Random Walk Down Wall Street* has used the phrase “Irrational Complacency” to describe the current lack of concern over a potential meltdown.

Hedge Funds

Hedge funds are private investment pools for institutions and wealthy individuals. In the 1990s several hedge funds bought shares in affiliates of investment dealers and established joint back office arrangements, which gave them access to higher borrowing facilities – regulators allow securities dealers to take on more debt than other investors. Currently, there are more than 9,000 hedge funds, with an estimated $1.5 trillion of assets.

Hedge funds now use derivatives to lever their exposure. Investment dealers and banks are offering complex derivatives based on single stocks, baskets of stocks, market indexes, bonds, oil, etc. In many instances the form of the derivative contract used is a “total return swap”. In a swap contract an investment bank agrees to pay a counter party, the hedge fund client, the change in the market price of a stipulated security. In a regular margin debt arrangement a client can borrow 50% of the market price of a stock. A total return swap requires only 5% of the market price. If the stock rises the hedge fund’s rate of return will be far greater, however, if the value of the underlying security falls the leverage will work in reverse. The hedge fund would have to pay the counter party an amount equal to the decline in share value and transaction fees.

Hedge funds are under no obligation to disclose derivative transactions or borrowing levels. However, Citadel Investment Group, a $14 billion Chicago based hedge fund, had to disclose such information when it issued bonds last year. The bond offering document indicated its leverage ratio – the value of assets compared to its capital from investors – was ***13 to 1***. The filing indicated that it had acquired a total-return swap on a $400 million basket of securities. The swap was arranged last October and entitled the hedge fund to collect payments equal to the gain in all the securities comprising the basket.

Credit Suisse offers total-return swaps through its Delta One prime brokerage operation, while J.P. Morgan Chase offers them through its Master Swap program. Hedge funds “canvass the street” to find the derivative deals that require the least amount of collateral. The collateral used by hedge funds to secure these swaps, however, may be difficult to trade, and in a severe market decline, attempts to unwind these positions may lead to panic selling. The dealers don’t disclose the amount of total return swaps on their books.

[When swap deals go bad hedge funds have to make big payments to the derivatives counter party. Citadel offsets this risk by carrying a pool of easy-to-sell securities – U.S. treasury bonds – and maintains “internal risk and liquidity targets”.]

Private-Equity Firms

Private-Equity firms such as Kohlberg, Kravis, & Roberts (“KKR”), are investment funds that usually buy entire companies. KKR is currently the lead firm in the ‘take-out’ of Canada’s BCE (Bell Telephone). Loans to private-equity firms rose to $317 billion in 2006 from $51 billion in 2002. This statistic reflects more and bigger deals but sources indicate that the debt-component has increased relative to the cash generated by the companies being acquired.

http://www.kkr.com

[The Federal Reserve estimates that there is $21 trillion in corporate stock outstanding versus about $12 trillion in 2002.]

Investment Dealers

In 2006, Wall Street’s four biggest investment dealers financed $3.3 trillion of assets with $129 billion of shareholders’ equity – a leverage ratio of ***26 to 1***. In 2002, those same four firms financed $1.6 trillion of assets with $74 billion of equity – a ratio of ***22 to 1***. In the case of Goldman Sachs its ratio of assets to shareholders’ equity increased to ***25 to 1*** in 2006 from ***18 to 1*** in 2002. Goldman indicates the increased leverage came as a result of its conversion from a partnership to a public corporation and the need to match its competition. Goldman also indicates it has a pool of liquid assets of approximately $50 billion that it can sell if market conditions turn negative.

Goldman has a joint venture with the Bank of New York involving “repurchase agreements”. Goldman uses stock from its proprietary trading accounts and its hedge fund clients, selling the stock but agreeing to buy it back later. The cash received is in essence a temporary loan, allowing it to lever the debt secured by those stocks to 2% of their value ***(50 to 1)***. The leverage is defended on the basis, "The prime-brokerage lending business provides a stable recurring revenue stream with limited risk."

Selected Statistics

- Margin debt held by individual investors – amount borrowed from brokerage firms to buy stocks – totaled $293 billion in March versus $135 billion in 2002. The March margin debt represents the third straight month it exceeded the record set during the high-tech bubble in 2000.
- Prior to the 1929 crash, brokers' customers were allowed to buy stocks with as much as 90% margin debt. The Securities Exchange Commission currently limits margin debt to 50% of a stock's market price.
- Estimates by analysts of leverage at major securities firms, borrowing by hedge funds and margin loans to individuals, totalled $5.0 trillion in 2006 versus $1.8 trillion in 2002.
- Hedge fund borrowing amounted to $1.5 trillion last year compared to $180 billion in 2002.

Stock Market Outlook

The April 30th issue of the *Wall Street Journal* carried an excellent editorial-opinion entitled *Irrational Complacency?* by Burton G. Malkiel. The writer debated whether the stock market is correctly pricing strong growth and economic stability into its valuation, or, if it is being irrationally complacent in the face of substantial risks.

- Mr. Malkiel estimates long-run annual equity returns by adding today's dividend yield – approximately 2% – to the future growth rate of earnings and dividends – estimated at +5.5%. This would suggest that stocks are priced to produce 7.5% future returns. This is well below the +10.5% annual returns achieved from 1926 through 2006.
- Treasury bond yields at 4.75% are historically low. The spread between high-yield bonds and risk-free U.S. Treasuries is close to all-time lows.
- The prospective equity risk premium (the amount that stock returns exceed bond returns) of about 2.75% is well below the 5% equity risk premium earned since 1926.
- The VIX Index, measuring expected U.S. stock market volatility is historically low.
- Various surveys (polling) done by independent market monitoring firms suggest a high level of complacency – following the almost uninterrupted rise in the stock market since June of 2006.

Mr. Malkiel concludes, "These measures imply that financial markets are very relaxed about risk and that the world is a very stable place." In recent years recessions have been mild, earnings variability has moderated and inflation has been contained. Price-earnings multiples in the mid to high teens are clustered close to their long run average values. A shock to the system, however, may come from the geo-political environment where risk levels are judged to be extremely high.

- "The conflict between Sunnis and Shiites as well as the violence of Hezbollah and Hamas threaten to destabilize the Middle East region."
- Iran is engaging in virtually 'unchecked' nuclear belligerency and repeatedly targets Israel with confrontational rhetoric. Israel, however, has both nuclear weapons and 'deliverability'.
- "The energy-vulnerable European nations have large Muslim populations that are experiencing limited social integration, high unemployment and radical Islamist influence."
- There are also a number of macro-economic factors underlying the United States economy, which cause Mr. Malkiel concern. "Inflation and quality adjusted home prices are still more than 50% above

their averages throughout most of the 20th century." Measured savings rates in the United States are essentially zero, and the trade deficit is running at 7% of GDP. The share of after-tax corporate profits relative to GDP is almost 9% versus 5% during the 1970s – whereas, wages and salaries have fallen from 53% to under 46% since 1970 – the Dobbsian "Assault On The Middle Class!" (Lou Dobbs – CNN)

- The political agenda will become increasingly adverse towards the Bush administration as it enters the 2008 presidential year. There is a growing realization the "insurgents" do not want the United States to withdraw from Iraq. Democrat controlled 'Capital Hill' has yet to dwell in earnest into the financial cost of the war and the apparent lack of accounting for the huge amounts of money spent.

Mr. Malkiel, however, does include several arguments to rationalize today's market valuations. He states, "I believe that markets are high and risk spreads compressed because of a massive increase in world liquidity. A world awash in dollar-based purchasing power has helped to keep our interest rates low and the spreads on risk assets tight". Flows of money continue into private equity and hedge funds available for public investors. Malkiel concludes, however, "In our highly leveraged, narrow-spread markets, shocks to the system can have large destabilizing effects."

[The Diary's editors have chosen a 'bullet-summary' format to add additional commentary.]

- *Over the past several years the Diary has profiled the Putin orchestrated moves by which the Kremlin (KGB) has regained political and economic control over Russian society. Putin has essentially captured the Russian energy platform and has undertaken strategic moves into many other key industries. The United States is not a factor in the development (and control) of Russia's energy reserves.*
- *China and India's economies are growing at phenomenal rates – and are dealing with commensurate energy demands by securing foreign resources – at ever increasing premium prices. Western-based economic concerns are losing-out on these markets.*
- *The status of the United States as a world super-power capable of influencing an event with 'gun boat diplomacy' is being denigrated daily by the insurgent activity in Iraq. The apparent indifference (or implicit geo-political intention) of Russia and China to contain the nuclear ambitions of North Korea and Iran has left the United States to go it alone. The United Nations has been shown to be a meaningless entity unable to prevent suffering and political dislocation of the world's innocent civilians.*
- *The United States huge trade deficits are being financed offshore. The Bank of China is now one of the largest holders of United States treasury debt. This is where leverage has even reached the national state level. The Bank of China can be described as 'America's banker'. It has a 'call' on the United States – it can simply decide to start to sell its U.S. dollar denominated holdings – which could precipitate an even greater crescendo of selling in a "wind down" scenario.*
- *And finally… ... … the United States Army is understandably fatigued and 'war-weary'. The "coalition of the willing" has left a lot to be desired. Its traditional allies (Great Britain, Canada – in Afghanistan) have stood behind America – however, other key and important nations have not. The United States is now facing the eventuality of withdrawing from Iraq – simply because it has become too great a drain on its military and economic resources. There is actually fear in some circles that the Iraqi insurgents may attempt an unexpected but coordinated offensive similar to the surprise "Tet Offensive" of the Viet Nam War, with U.S. military ground forces pinned down and only limited means of extrication. This is a worst-case scenario and an example of a severe adverse geo-political event that would trigger a melt down.*

[It is doubtful that the Pentagon has war-gamed anything like this!]

__Selected Quotations__

- "It's easy to put on leverage, but not as easy to take it off." *…Warren Buffet*
- "Total-return swaps make a mockery of margin requirements". – The widespread use of swaps makes the leverage that preceded the 1929 crash – "Look like a Sunday-school picnic." *…Warren Buffet*
- With hedge fund managers now collecting management fees of 1% to 2% – or even higher – on billions of dollars, "they are extraordinarily well compensated". "I used to say that I should not make a dime unless my investors made a dime and the 1% management fee was supposed to be enough just to pay expenses" *…Michael Steinhardt*
- What's his take on today's stock market? "The bell is beginning to ring. We are not too far from the end of the bull market." *…Michael Steinhardt*
- A trillion dollars here! …A trillion dollars there! Suddenly we are talking "serious money" *…Anonymous*
- Twenty-five and fifty to one ratio – nothing compared to my ex-wife – she ran 100 to nothing ratios with my credit card! *…Anonymous*

*[The OSINT **Law of Stalingrad Syndrome** – "The finality of an outcome is certain – only the entrapped are ignorant of the finality." … … … Does it apply to today's situation?*

The Editors have purposely chosen to highlight with underlined, bold, italic text the various leverage ratios in play in today's capital markets. The aforementioned ratios are awesome! The Editors include one money-manager who does not engage in leverage at all in his clients' traditional portfolios – in fact he is only approximately 40% in the stock market on a non-borrowed basis. He does run a private financial derivatives fund, however, the fund has never surpassed a 5 to 1 leverage ratio – and in many instances over the four-year history the positions have been 'short the market'. A 25 to 1 long position would cause this portfolio manager cardiac arrest – not to mention a terminal case of 'strangulated sphincter muscles'!]

The Editors do not want to see any severe adverse situation develop in the capital markets – however, prudent investors should be aware of the risk in the market place and how increasingly the probability is growing that geo-political risk may converge to ignite the melt down. We hope our concerns are unfounded – however, we are hedging our bets – and we are sleeping well at night – very soundly actually!]

The Editors used three articles to prepare this précis. We would like to reference them in full recognition of copyright requirements. All three articles are outstanding! Burton Malkiel and Michael Steinhardt are legends in the investment business. The Diary's editors consider it an honor to even reference these men through our précis summaries. Not only do we fully acknowledge copyright authority we also compliment them for their outstanding contributions to the world of finance.

Barron's – Talking With Michael Steinhardt – A legend Lashes Out, April 30th, 2007

Wall Street Journal – Irrational Complacency, April 30th, 2007

Wall Street Journal – As Funds Leverage Up, Fears of Reckoning Rise, April 30th, 2007