

The Forgotten Lessons of 2008 (20 lessons of the financial crisis, from Baupost annual letter)

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stormy weather. Securitization is an area that almost perfectly fits this description; markets for securitized assets such as subprime mortgages completely collapsed in 2008 and have not fully recovered. Ironically, the government is eager to restore these securitization markets back to their pre-collapse stature.¹¹ Ratings agencies are highly conflicted, unimaginative dupes. They are blissfully unaware of adverse selection and moral hazard. Investors should never trust them.¹² Be sure that you are well compensated for illiquidity – especially illiquidity without control – because it can create particularly high opportunity costs.¹³ At equal returns, public investments are generally superior to private investments not only because they are more liquid but also because amid distress, public markets are more likely than private ones to offer attractive opportunities to average down.¹⁴ Beware leverage in all its forms. Borrowers – individual, corporate, or government – should always match fund their liabilities against the duration of their assets. Borrowers must always remember that capital markets can be extremely fickle, and that it is never safe to assume a maturing loan can be rolled over. Even if you are unleveraged, the leverage employed by others can drive dramatic price and valuation swings; sudden unavailability of leverage in the economy may trigger an economic downturn.¹⁵ Many LBOs are man-made disasters. When the price paid is excessive, the equity portion of an LBO is really an out-of-the-money call option. Many fiduciaries placed large amounts of the capital under their stewardship into such options in 2006 and 2007.¹⁶ Financial stocks are particularly risky. Banking, in particular, is a highly leveraged, extremely competitive, and challenging business. A major European bank recently announced the goal of achieving a 20% return on equity (ROE) within several years. Unfortunately, ROE is highly dependent on absolute yields, yield spreads, maintaining adequate loan loss reserves, and the amount of leverage used. What is the bank's management to do if it cannot readily get to 20%? Leverage up? Hold riskier assets? Ignore the risk of loss? In some ways, for a major financial institution even to have a ROE goal is to court disaster.¹⁷ Having clients with a long-term orientation is crucial. Nothing else is as important to the success of an investment firm.¹⁸ When a government official says a problem has been "contained," pay no attention.¹⁹ The government – the ultimate short-term-oriented player – cannot withstand much pain in the economy or the financial markets. Bailouts and rescues are likely to occur, though not with sufficient predictability for investors to comfortably take advantage. The government will take enormous risks in such interventions, especially if the expenses can be conveniently deferred to the future. Some of the price tag is in the form of back-stops and guarantees, whose cost is almost impossible to determine.²⁰ Almost no one will accept responsibility for his or her role in precipitating a crisis: not leveraged speculators, not willfully blind leaders of

financial institutions, and certainly not regulators, government officials, ratings agencies or politicians. Below, we itemize some of the quite different lessons investors seem to have learned as of late 2009 – false lessons, we believe. To not only learn but also effectively implement investment lessons requires a disciplined, often contrary, and long-term-oriented investment approach. It requires a resolute focus on risk aversion rather than maximizing immediate returns, as well as an understanding of history, a sense of financial market cycles, and, at times, extraordinary patience.

False Lessons

1. There are no long-term lessons – ever.
2. Bad things happen, but really bad things do not. Do buy the dips, especially the lowest quality securities when they come under pressure, because declines will quickly be reversed.
3. There is no amount of bad news that the markets cannot see past.
4. If you've just stared into the abyss, quickly forget it: the lessons of history can only hold you back.
5. Excess capacity in people, machines, or property will be quickly absorbed.
6. Markets need not be in sync with one another. Simultaneously, the bond market can be priced for sustained tough times, the equity market for a strong recovery, and gold for high inflation. Such an apparent disconnect is indefinitely sustainable.
7. In a crisis, stocks of financial companies are great investments, because the tide is bound to turn. Massive losses on bad loans and soured investments are irrelevant to value; improving trends and future prospects are what matter, regardless of whether profits will have to be used to cover loan losses and equity shortfalls for years to come.
8. The government can reasonably rely on debt ratings when it forms programs to lend money to buyers of otherwise unattractive debt instruments.
9. The government can indefinitely control both short-term and long-term interest rates.
10. The government can always rescue the markets or interfere with contract law whenever it deems convenient with little or no apparent cost. (Investors believe this now and, worse still, the government believes it as well. We are probably doomed to a lasting legacy of government tampering with financial markets and the economy, which is likely to create the mother of all moral hazards. The government is blissfully unaware of the wisdom of Friedrich Hayek: "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design.")

VII

STRATEGY:

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