Recent Events

In the past two decades several financial disasters took place: the stock market crash of 1987, the Japanese financial crisis that began in ’90, the implosion of the Nordic Banking system in ‘92, the Tequila Crisis in ‘94, the Asian Crisis of ‘97-‘98, and the deflation of the Telecom-Media-Technology bubble in 2000-2002. Today we are painfully experiencing the liquidity/credit crunch that began late in spring of 2007. Stalwarts such as AIG, HBOS, Bradford and Bingley, Northern Rock, Washington Mutual, Wachovia, Bear Stearns, Merrill Lynch and Lehman Brothers have all vanished within the last few months. With the benefit of hindsight, it is clear that these failures are the result of managerial mistakes, compounded by excessive use of leverage. In the last few years, financial innovation has developed at a rapid pace with the effect of increasing both the complexity and the interrelation of the world’s financial systems. The markets’ regulation has not kept up with these developments and as a consequence greed, speculation, poor policy and stupidity prevailed over rules, prudence and common sense. The aftermath is in yesterday’s and today’s headlines. Widespread panic, frozen credit markets and numerous and sizable hedge funds facing redemptions and margin calls is creating forced selling across broad sectors of the capital markets. In a world that tries to de-leverage simultaneously (banks, hedge funds) sellers have pushed prices down very quickly. Other investors, spooked by market declines, have also run for the exits, adding fuel to the fire. The S&P 500 has been roughly cut in half in 12 months with accelerating speed (20% in the first week of October only).

We told you that stocks were cheap at the beginning of 2008, what went wrong?

Excessive valuations are normally the cause of bear markets: extremely high price-to-earnings ratios render competing investment opportunities, such as fixed income, attractive substitutes. Stocks are sold and proceeds redeployed in more compelling alternatives, readjusting relative prices and bringing back equilibrium in prospective returns. This process typically feeds on itself until stocks look more attractive than bonds and the whole cycle repeats. This time, however, stock P/E ratios were not high by historical standards and competing bond yields were not compelling in comparison. On the contrary, the major excesses had occurred in credit, where risk premia virtually disappeared. A prolonged period of very low interest rates and low volatility fueled excessive leverage and risk taking, and led to excessive valuations mostly in commodities and real estate. What we underestimated then, was the fact that due to this leverage, the systemic risk grew tremendously, putting in danger all asset classes. We have learned the hard way that in a global economy risks are higher than ever, as the world’s financial systems are connected to each other and an outburst of panic can now spread easily across the entire planet, in the same way that a pandemic flu can. What started out as a real estate problem in certain areas of the US had repercussions in unexpected places such as German regional banks and Japanese Insurance companies. People slowly realized the fragility of the system, trust disappeared, and many financial institutions that relied heavily on capital markets for their ongoing liquidity needs found themselves in a corner. Even a solid company like General Electric needed an emergency capital increase and demanded the support of Warren Buffett: heavy reliance on commercial paper funding put an otherwise healthy business at risk. It was very hard to predict that fear and irrationality would paralyze funding mechanisms that functioned seamlessly for decades, but our mistake has clearly been to underestimate the vulnerability of certain financial institutions to such a scenario. Due to the need to terminate the notion of moral hazard (i.e. the idea that bankers can take huge risks and cash in handsome rewards in good times and be bailed out in bad ones), initial interventions by the governments have followed the path of letting shareholders and occasionally bondholders suffer huge losses. As a consequence, even strong franchises with valuable assets such as AIG have seen their equity be almost entirely wiped out. Most recently, Royal Bank of Scotland came very close to bankruptcy, as their credit spread started to widen dramatically due to upcoming bond maturities and the fear that lack of investors would prevent the bank from being able to roll its funding over. In conclusion, very valuable institutions have seen quasi-total equity losses not because their intrinsic value went to zero but because their short sighted funding policy left them exposed and vulnerable to a system shock. As analysts, our mistake has been to underestimate the importance of the funding structure and the company culture and overly rely on the discrepancy between price and underlying intrinsic value, difference that cannot ultimately be cashed in if capital markets temporarily fail forcing a fire sale liquidation of the assets.

What to do now

All major governments have finally reacted, and after an initial uncoordinated response made of ad hoc interventions, all policy makers have decided to act resolutely. Most plans envisage guarantees of deposits and of bank bonds, as well as equity injections in major banks. Policy makers have fully realized that wiping out shareholders achieved the effect to increase panic and keep desperately needed private capital away. As a consequence, shareholders are not being penalized any more than they have already been, and liquidity and refinancing risks have largely disappeared. For most financial institutions, stock prices have declined far more than their estimated value. Therefore, their discount to value has grown. And for the survivors, the current turmoil has provided opportunities to make acquisitions that appear to have been real bargains. These companies sell at low price-to-earnings and price-to-book ratios, have value additive acquisition opportunities, and face less competition than they previously did. We believe the winners will emerge as very strong companies. Commenting about the Paulson plan and mortgage securities, Warren Buffett recently said that “People who are buying these instruments in the market are expecting to make 15 to 20 percent…If they (the government) do it right…I think they’ll make a lot of money.” We are strongly convinced that capitalism will survive. The spectacular failures of 2008 will result in a more prudent, simpler system that, at least for a while, has cleansed itself of the weak and marginal players, while the stronger have survived and will strengthen their positions. Adversities also sharpen focus and favor prudence, more reasoned risk-taking and improved regulation. At least for a few years, we will have learned our lesson.

These are unique and challenging times. We are going through one of the strongest financial storms ever occurred, and we have made some mistakes. However, it is our job to keep our heads cool, learn from mistakes and assess the situation looking forward and not in the rear window. Most of our holdings are dramatically undervalued and liquidity risks have largely disappeared, while the markets are extremely irrational, as demonstrated for example by the still very high yields on UK bank bonds despite being now equivalent to UK government bonds.

Thanks for your patience and support.

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October 2008

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