



Friday, March 13, 2009

## **HOW MUSICAL LOANS ENDED ON A SOUR NOTE, AND HOW WE ARE LEARNING TO PUT THE NEEDLE BACK ON TRACK**

“We have nothing to fear but fear itself.” Franklin Roosevelt made that statement famous. It is a powerful phrase because it is succinct and because it captures the power of free flowing anxiety, a force that is insidious and relentless in its destructive effect. Whether you agree with his political philosophy or not, one would say that Roosevelt was an effective politician who knew the power of language and words. He understood that fear was powerful because it could not be quantified or limited, or contained mathematically.

Fear is powerful because we cannot put time limits on it, and we cannot confine it to certain subjects. Fear can immobilize those who were imprisoned by it. Roosevelt knew that fear can become most virulent and self-destructive when there is no plan of action, no agreement on how to tackle a stagnant or contracting economy, and no clarity about which actions to take to reinvigorate the economy.

The answer to fear is a plan of attack based on consistency and clarity. While it is easy to criticize both Democratic and Republican leaders for missteps which they have taken to get the economy going again, it is also important to remember that the intangible we call the economy is a complex organism with millions of parts and an often unpredictable chemistry. In any case, our leaders have made some promising decisions to fix what is wrong, decisions, which I shall analyze in this letter later on.

In the meantime, it may be instructive to review the forces that led to the recession that started in 2007 to see what the probable path of recovery is, and how, as we take steps to reform our institutions and to encourage private capital to take risks again, fear will succumb to action and a plan of attack.

Almost every boom witnesses increases in debt, low interest rates, and the use of esoteric financial instruments whose risk is thought to be understood at the time they are created or engineered, but whose real dangerous and risky substance are only apparent after these instruments have done their damage. Only after the dust has settled and the aftermath of excessive expansion is obvious do we often realize that we had misunderstood and mispriced certain financial instruments. The last boom, which began in 2001 and ended in 2007, saw unprecedented increases in consumer debt, and the heavy use of mortgage backed securities, with many mortgages bundled together and packaged and with guarantees of payment of interest and principal by Freddie Mac or Fannie Mae.

Low interest rates encouraged aggressive lending and reckless borrowing, developments which quickly led to mountains of debt.

Banks relaxed lending standards in the last bull cycle so that the definition of creditworthy became hazy. Standards were so loose that bankers often did not verify income nor liabilities as they rushed to approve loans on million dollar houses to young borrowers who had barely graduated from college and were just beginning to enter the workforce.

Credit was cheap, it was easy to get, and the temptation to use it became hard to resist.

Many, seduced by an apparently inexpensive avenue to a lavish lifestyle, embraced a life of fantasy, perhaps irresponsibility. Who was to blame? Was it the borrowers, who exaggerated their incomes, and minimized their expenses, or was it the bankers who teased the borrowers with rates that started low, but jumped astronomically after a few years?

Sometimes it seemed as if the country was attending one big party, with the price of admission (low interest rates) encouraged by the Federal Reserve. It appeared that the party would never end, and that the music would never stop.

Borrowers and bankers were soon consumed by an orgy of debt creation as prudence and parsimony succumbed to overconsumption and mindless self-destructive risk.

The best party was in real estate where banks strove to outcompete each other with attractive offers to the would be homeowner. The most seductive merchandise was the adjustable rate mortgage which was designed to seduce the borrower with an artificially low rate, a rate that the bankers publicly and privately called a teaser. At the signing of the mortgage, the rate was low, but the buyer understood that it could be set higher a few years later, after banker and borrower signed off on the loan, and at a rate often multiples of the original rate, so that a naïve homebuyer would start at a thousand dollars a month and five years later would be faced with a three thousand dollar a month commitment.

The fact that the rate could jump significantly but the excitement of buying a new house with more space was a temptation too great to resist and the opportunity to enjoy some [conspicuous consumption](#) was a pleasure too powerful to forego.

Indeed, the borrowers found that bankers were quite adept at the teasing game. I have long known how skillful bankers are with teasing, and that is why I have never allowed bankers to tease me, even though I encourage other people to do so. People tell me that they like to tease me. I do not mind being teased. But I never let bankers tease me. It is too expensive.

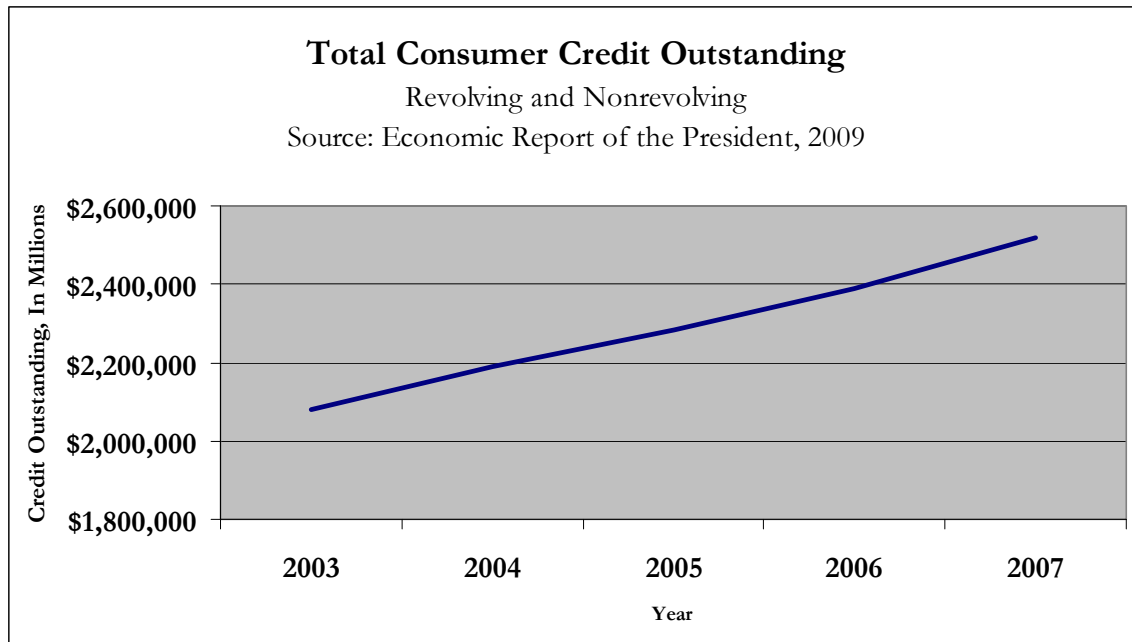
The culture of over consumption or conspicuous consumption led people to buy over sized homes and to purchase suits and dresses that they never wore. These dresses and suits often found a permanent place in the closet, with their price tags still on.

[Conspicuous consumption](#) was not new. Nor was the concept of the leisure class. [Thorstein Veblen](#) understood both concepts well, as he demonstrated in [The Theory of the Leisure Class](#), published in 1889.

[Veblen](#) wanted economists to grasp the effects of social and cultural change on economic changes. In [The Theory of the Leisure Class](#), which is probably his best-known work, because of its satiric look at American society, the instincts of emulation and predation play a major role. People, rich and poor alike, attempt to impress others and seek to gain advantage through what [Veblen](#) coined '[conspicuous consumption](#)' and the ability to engage in '[conspicuous leisure](#).' In this work [Veblen](#) argued that consumption is used as a way to gain and signal status. Through '[conspicuous consumption](#)' often came '[conspicuous waste](#)', which [Veblen](#) detested. Much of modern advertising is built upon [Veblen's](#) notion of consumption. (*Wikipedia 2009*)

Often the homebuyer would not consider seriously the odds of tripling his monthly salary in three years, a tripling necessary to meet the mortgage when the monthly payment was adjusted. Eager homebuyers did not put up much resistance to the sophisticated teasing that the banks offered, as adjusted rates appeared to be so far into the future as to be nothing but fantasy. Furthermore, many

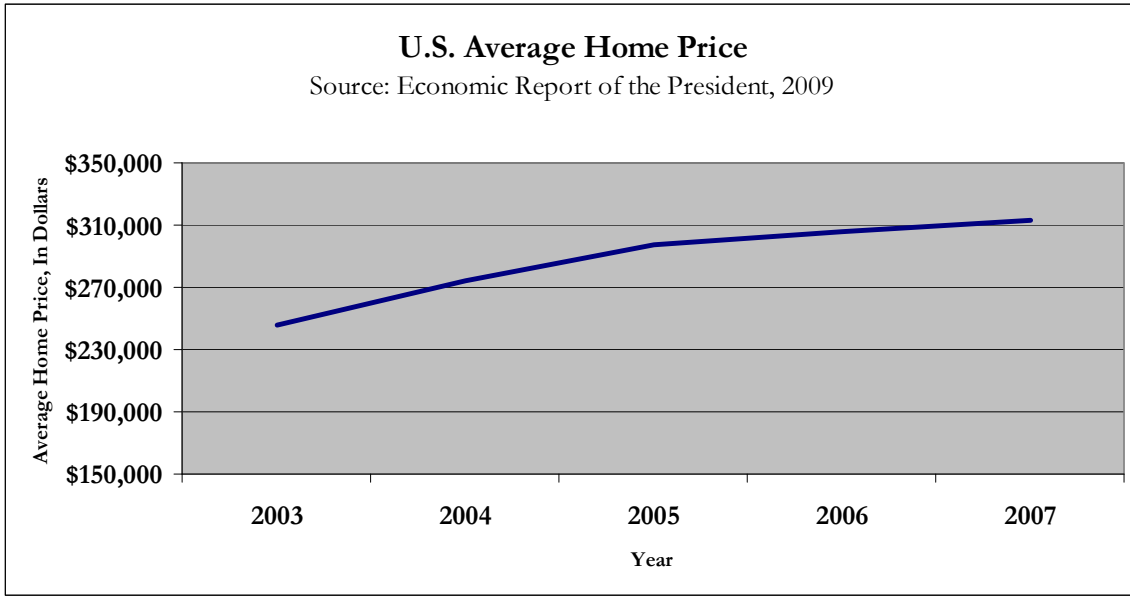
borrowers reasoned, if a personal situation got tight, you could always sell or flip your house, as housing prices rose every year, a phenomenon, they believed, that was guaranteed.



Owning a house was long considered the American dream, as uniquely American as rising from the lower class to the upper class. In the last boom, however, owning a house often became a means of financing, of taking a risk, hoping to live in a house only long enough to sell it, assume another small percentage down payment, and move to another, larger house, which would be a home only long enough to sell it and finance another house. This game was risky, it had to end sometime as [musical homes](#) or [musical loans](#) was not a game you could play indefinitely and win.

Why buy a comfortable two bedroom house if you were a middle class couple without any children when with a little help from an eager banker desperate to make his monthly loan quota the couple could swiftly capture a loan to put themselves in a ten thousand square foot house with a pool with waterfall and hot tub, a fitness room, an entertainment room, a wet bar, a family room, a dining room (even though the family, like myself, almost always dined out) and a kitchen with a Viking Range (even though no one cooked a meal at home more than once a quarter) and a library, even though no one read, but spent their leisure time in the entertainment room facing a twenty thousand dollar plasma television equipped with a wonderful [Dolby surround sound](#)?

In the last boom, a fixed rate mortgage, with or without a prepayment option, was only for old folks. Why take a six per cent rate when you could get a three per cent rate, even if this rate were ominously called a teaser rate? Interest rates were low and Alan Greenspan wanted to keep them low, despite his mumbo jumbo about irrational exuberance in the stock market. Money, especially money for mortgages, was cheap and if some of the mortgages contained a provision for upward adjustment, this was nothing to worry about, as interest rates would always stay low and house prices would rise forever. Was that not true?



The thirty year fixed rate mortgage became an anachronism, a fossil of a period when people buying a home actually intended to live in the house, took seriously their ethical and monetary obligation to make monthly payments on time, and the loan officers did a diligent check and performed a thorough appraisal of the borrowers' ability and willingness to live up their duties. The bankers did not try to sell more home than the buyer could afford and the buyers bought within their means. This was a staid, safe era in which bankers were finance people and not merchandisers.

Before the last real estate boom, research on the loan applicant was, believe it or not, actually a requirement for doing due diligence. Bankers had to verify income and other sources of cash flow, and had to appraise the borrowers' assets and liabilities carefully. After all, the banker's cash and reputation were on the line.

But the upstream sale of loans to [Fannie Mae \(Federal National Mortgage Association\) \(NYSE: FNM\)](#) and [Freddie Mac \(Federal Home Loan Mortgage Corp\) \(NYSE: FRE\)](#) changed the rules and the dynamics of risk.

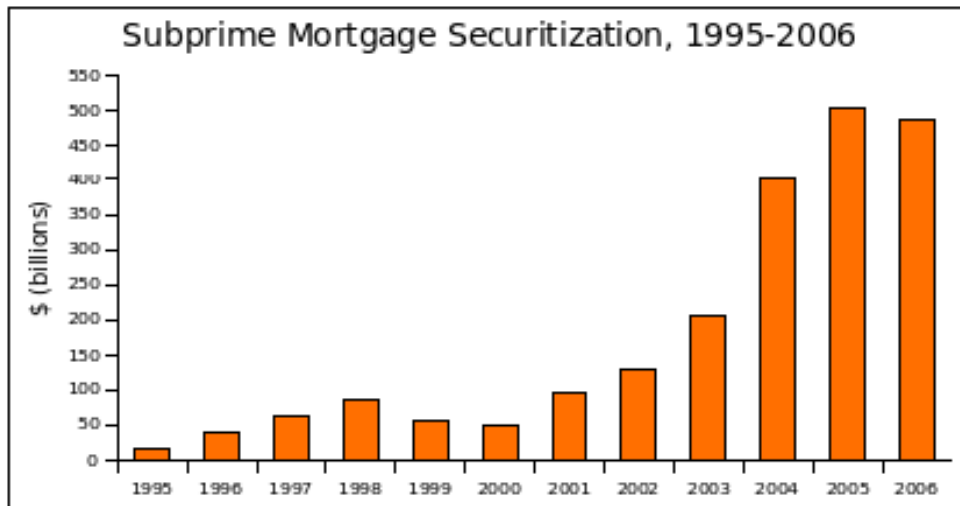
Banks, eager to rack up revenue, and to reduce risk, sold their loans to either Fannie Mae or Freddie Mac, or to investment banks. These entities would then repackage these loans and sell an interest in them to investors such as hedge funds, pension funds, and sovereign wealth funds.

But when you could package and ship, due diligence soon became a disappearing art and a neglected discipline. This was packaging as the bankers drifted away from the personal intimate knowledge of the customer.

Someone had insure these securities and [American International Group, Inc. \(NYSE: AIG\)](#) came to the forefront (some believe it was a rescue) selling credit default swaps, a fancy term for a complicated product that offered insurance against default to those bondholders willing to pay for such protection.

Sometimes the loans were sent to Washington, some times to investment banks, such as [Lehman](#) and [Bear Stearns](#). In any case, securitizations rose rapidly, as the stakes in the game of [musical loans](#) rose to a dangerous level. To see the danger, look at the chart on page five detailing the rise in subprime securitizations. This game of [musical loans](#), however, could not last forever. As soon as the economy

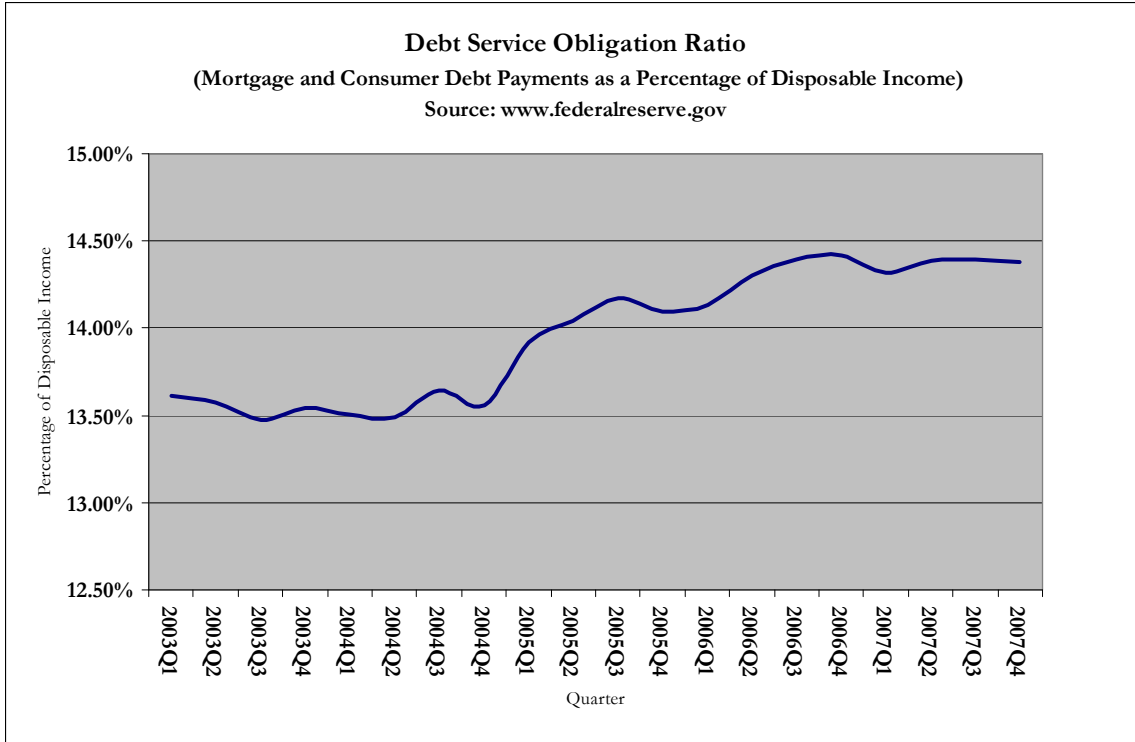
slowed down, and workers were laid off, banks would find that the mortgages on the over appraised houses would not be collectible.



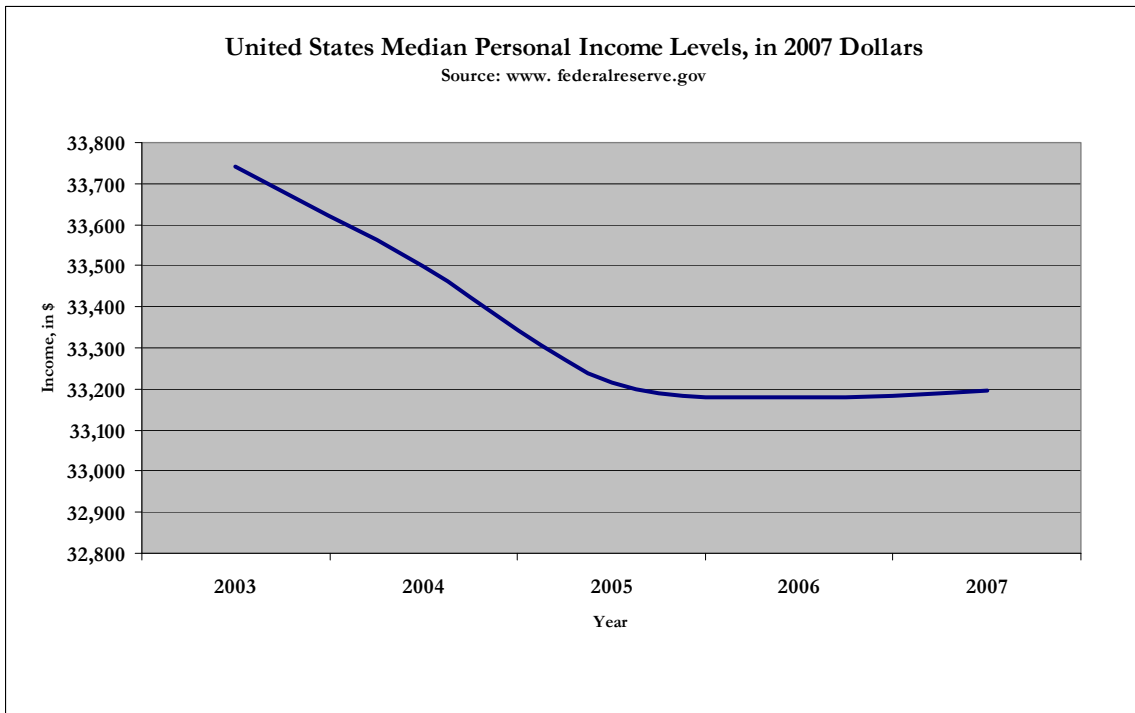
For many years this debt did not cause problems, as interest rates were at low levels for most of this decade, even dropping dramatically after September 11, 2001.

The party ended when the Federal Reserve, surprising many, began in 2005 to raise the federal funds rate, and easy cheap credit was no longer a right. The housing market soon peaked and the economy soon slowed. With payments much higher than they ever wanted to consider, homeowners, or more accurately homebuyers, now faced a very unpleasant fact: they were not rich, a good portion of their monthly income would now have to go toward meeting their mortgage, and they would have to cut back, and drastically, their expenditures on many items. As this phenomenon played out, the economy slowed down. The adjustable rate loan, along with the home equity loan, was now an extremely painful reality.

Suddenly millions of homeowners were caught in a vise. Their expensive lifestyle had been financed by cheap rates. Their wages and other sources of income had grown slower than the rise in home prices. Something had to give when their mortgage rates were set higher, much higher. Millions of homeowners could not now make their monthly payment. They defaulted, foreclosures rose rapidly, and banks, now starved for cash on their balance sheets, stopped lending, sending businesses into failure and bankruptcy, and precipitating the layoff of millions of workers who then stopped going to Starbucks, stopped buying SUVs, and other wise stopped spending, an act, multiplied millions of times, that put the brakes on the economy.



The chart on page five illustrates the increasing role debt played in the average American's life over the last ten years. Increased debt levels have financed an unprecedented increase in consumer spending and home mortgage acquisition. The chart shows that the monthly mortgage began in the first quarter of 2005 to take a bigger and bigger bite out of the consumers' monthly paycheck.



While the American consumer practiced their skills at spending beyond their means, as long as house prices moved upwards everyone seemed happy. But when house prices began to peak it became apparent that the number of millionaires was much smaller than the ads for Mastercard might suggest. In fact, there were many ten thousand dollar millionaires. Yes, certain things were, as the Mastercard commercials intoned, priceless, but there were many material items that the false millionaires were no longer allowed to buy, at least on credit .

When the crash came, it was monumental. Millions of people lost their homes, and their jobs. It was all too painful, living from paycheck to paycheck.

Washington made some good moves, but, not surprisingly, it has been the private sector that has seized the opportunity to buy distressed assets at distressed prices, helping to jumpstart the economy. As bankers looked on they decided to get back into the party and they have opened up their balance sheets to more deposits and hence to more loans to real estate entrepreneurs who are offering cash. In all the anguish and confusion and heated debate that the present recession has produced, it is important to know that our economy has not come to a standstill. Millions of people are working, and banks are making loans and they are making profits. And smart businesses, realizing that fear has gone way beyond reality, and that businesses are borrowing, and beginning to hire workers back, even if slowly, see that their debt is absurdly priced.

For example, [The Wall Street Journal](#) reported on Thursday, March 12 that Glencore International AG has bought back more than one hundred million dollars of its own debt and may buy more.

‘Debt-refinancing requirements in the short term remain modest, supported by a broad banking group of more than 75 financial institutions,’ the Switzerland-based commodities firm said Wednesday.

Market participants told Dow Jones Newswires that Glencore repurchased bonds of varying maturities at a discount to face value, with the market currently in the region of 57% to 65%. The company declined to comment on the prices it paid.

Banks are now beginning to make money.

On Tuesday, March 10, [Citigroup, Inc. \(NYSE: C\)](#) announced that it enjoyed an operating profit for the first two months of the year. All the major indexes soared more than 3.5 percent, and the [Dow Jones Industrials](#) shot up more than 250 points.

In a letter sent to employees Monday, [Citi](#) Chief Executive Vikram Pandit said the first-quarter performance so far had been the bank's best since the third quarter of 2007, the last time it recorded net income for a full period. Based on historical revenue and expense rates, [Citi's](#) projected earnings before taxes and one-time charges would be about \$8.3 billion for the full quarter. ([Dow Jones Newswires](#), March 10, 2009)

Behind the scenes, and not fully reported by [The Wall Street Journal](#), [The New York Times](#), and [The Financial Times](#) are deals being done by vulture real estate investors, deals with other investors and with banks. And when there are not deals, there are serious negotiations. Entrepreneurs are seeing bargains that they have not seen in years. They see the possibilities of huge capital gains in the anxious

and distressed securities and real estate markets with prices --in terms of earnings per share and cash flow per share--not seen for many years.

This is the time that vulture funds begin to get active, as they were in the early 1980's in the states which saw the most powerful effects of the oil boom and the oil bust, when ultimately banks and private investors, working with the Resolution Trust Company, pounced on bargain assets, cleared the market of slow moving or nonmoving real estate, and helped restart the economy. Vulture funds, especially, are getting aggressive as they see distressed and/or abandoned real estate begging to be sold by those desperate for cash.

Bank balance sheets are clogged with overvalued or overpriced assets because they are unwilling to sell these assets at prices hedge funds and other investors are willing to pay. There is a gap between the bid and the ask that could be bridged in many ways. Some have proposed nationalization as the answer and some have proposed a significant equity interest by the government. There are billions and billions of assets that are subject to negotiation, but this is not the first time that the nation has suffered illiquidity in the housing market, and in other markets.

The economy is weak, but there have been some signs that the job market has stabilized and that the housing market--in a small number of states admittedly has improved. Liquidity is far from what we need it to be, but it is improving, and that should reduce fear and boost self-confidence. Purchases, for example, of commercial paper by the Federal Reserve System have produced liquidity. As the liquidity deepens, fear will dissipate and lending will pick up, leading to self-reinforced positive cycles.

As government and private sectors work toward solutions to our stagnation, it is instructive to keep some perspective, as [Warren Buffett](#) pointed out in his latest shareholder letter:

Amid this bad news, however, never forget that our country has faced far worse travails in the past. In the 20th Century alone, we dealt with two great wars (one of which we initially appeared to be losing); a dozen or so panics and recessions; virulent inflation that led to a 21 1/2% prime rate in 1980; and the Great Depression of the 1930s, when unemployment ranged between 15% and 25% for many years. America has had no shortage of challenges.

Without fail, however, we've overcome them. In the face of those obstacles – and many others – the real standard of living for Americans improved nearly *seven*-fold during the 1900s, while the Dow Jones Industrials rose from 66 to 11,497. Compare the record of this period with the dozens of centuries during which humans secured only tiny gains, if any, in how they lived. Though the path has not been smooth, our economic system has worked extraordinarily well over time. It has unleashed human potential as no other system has, and it will continue to do so. America's best days lie ahead.

*Berkshire Hathaway Inc., 2008 Annual letter to the Shareholders, page three*

Let us now look at our portfolio, a portfolio constructed with the idea that the best offense is as good defense. The balance sheets, competitive position, and technological edge of our companies will put them in good position when the tough part of the cycle ends. Let's consider [Sun Hydraulics \(NASDAQ: SNHY\)](#) as an example.

During a public call to review fourth quarter 2008 results, I asked Allen Carlson, the company's CEO, what happened in the last year with respect to Sun's competitive position. Many companies, Carlson

responded, companies with lots of debt, had gone out of business leading to more market share for Sun. (You may listen to the [Sun Hydraulics](#) Tuesday, March 3 earnings conference call by going to [www.sunhydraulics.com](http://www.sunhydraulics.com), click on Investor Relations, then click on Events and Presentations and you will see the 4th Quarter 2008/Year End Conference Call.)

After listening to Carlson, I did a little research to find out why he did not have much fear about the current recession. I used the numbers reported in the 2000-2001 recession to evaluate Carlson's confidence.

[Sun](#) first experienced the recession of 2000-2002 in the first quarter of 2001 when its sales declined to \$18.9 million from \$20 million for the first quarter of 2000. The company's revenues declined during the 2001-2003 period but by 2004 sales were at a record. Only during one quarter, the fourth quarter of 2001 did Sun record a loss.

Below is a chart, produced as of March 5, 2009, which depicts the common stock price of [Sun Hydraulic's](#) stock from 1997 through the first two months of 2009.



## Sun Hydraulics: Profitable Even In Recessions

(In thousands except per share data)

| <b>Quarter</b> | <b>1999</b>     |               | <b>2000</b>     |               | <b>2001</b>     |               | <b>2002</b>     |               | <b>2003</b>     |               | <b>2004</b>     |               |
|----------------|-----------------|---------------|-----------------|---------------|-----------------|---------------|-----------------|---------------|-----------------|---------------|-----------------|---------------|
|                | <b>Sales</b>    | <b>EPS</b>    | <b>Sales</b>    | <b>EPS</b>    | <b>Sales</b>    | <b>EPS</b>    | <b>Sales</b>    | <b>EPS</b>    | <b>Sales</b>    | <b>EPS</b>    | <b>Sales</b>    | <b>EPS</b>    |
| <b>First</b>   | \$18,465        | \$0.11        | \$20,069        | \$0.13        | \$18,979        | \$0.16        | \$15,613        | \$0.02        | \$16,400        | \$0.04        | \$21,400        | \$0.20        |
| <b>Second</b>  | \$15,921        | \$(0.03)      | \$21,896        | \$0.21        | \$17,533        | \$0.07        | \$17,413        | \$0.12        | \$18,900        | \$0.12        | \$26,500        | \$0.38        |
| <b>Third</b>   | \$17,664        | \$0.09        | \$19,973        | \$0.16        | \$15,119        | \$0.02        | \$16,043        | \$0.08        | \$17,900        | \$0.08        | \$23,200        | \$0.27        |
| <b>Fourth</b>  | \$17,500        | \$0.10        | \$17,500        | \$0.07        | \$13,400        | \$(0.10)      | \$15,500        | \$0.16        | \$17,050        | \$0.09        | \$23,400        | \$0.29        |
| <b>Total</b>   | <b>\$69,652</b> | <b>\$0.28</b> | <b>\$79,967</b> | <b>\$0.60</b> | <b>\$64,983</b> | <b>\$0.14</b> | <b>\$64,545</b> | <b>\$0.27</b> | <b>\$70,798</b> | <b>\$0.33</b> | <b>\$94,503</b> | <b>\$1.14</b> |

**Notes:**

- 1) Sales are in blue.
- 2) EPS (Earnings per share) are in green, unless negative when they are in red.

We look for companies that have consistently increased their dividend payout. We view this as a sign of commitment to shareholders and indicative of financial strength. Firms that are able to regularly increase their dividend payouts are generating adequate cash flow. In business, cash is king, and this principle rings even truer in a difficult economic climate. (If you are a feminist, then cash is queen.)

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Many thanks to Meredith Bohot and Stephen Shepherd for their help with the research that we used for this letter.

Clients, officers, shareholders, and employees of the Fredric E. Russell Investment Management Co. have a position in Sun Hydraulics Corporation, a position of 155,000 shares, of which Fredric E. Russell owns 25,275.