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Alternative Investment Strategies

Crony Capitalism

The U.S. stock market continued its upward trajectory from the early March lows with all major indices rallying significantly during the month. The DJIA rose 7.56% and the S&P 500 rose 9.57% to bring the indices closer to positive territory for the year. Year to date, the DJIA is now down only -5.86% and the S&P is down -2.49%, recovering the majority of their first quarter drawdowns. Technology continues to lead other sectors of the economy as evidenced by the strong outperformance of the NASDAQ Composite which rose 12.35%, bringing the year to date return to +8.89%. A mixture of positive economic news and better-than-expected earnings reports from several firms, most notably Wells Fargo, has brought a fresh wave of optimism and talk of economic recovery. Even a worse-than-expected GDP figure showing the market contracted at an annual rate of 6.1% (the market was expecting -4.0% to -4.7%) could not derail the current rally as investors chose to focus on the positive consumer confidence reports and better-than-expected construction spending and pending home sales figures to further buoy stock prices. However, the optimism of the past two months needs to be put into perspective as the economy continues to contract and unemployment has yet to peak as companies downsize and restructure. Stock markets are still more than 40% off of their 2007 highs. A quick history lesson will show that prior post-crash markets have had numerous bull market rallies before eventually emerging from the grips of those long term secular bear markets. During the Great Depression, between 1929 and 1932, the DJIA rallied by more than 20% four times before falling back to its previous lows. The current crisis has already seen five separate rallies of more than 10%, in most cases giving up most of those gains.

The current recession has certainly had some surprises for the global markets. The speed with which the global slowdown spread surprised most investors as there proved to be few investment safe havens. However, recessions are not just about the numbers. They also reveal some of the worst characters among us. During the last recession, after the tech bubble burst, it was Bernie Ebbers, Tom Kozlowski and "The Smartest Guys in the Room" at Enron that became the poster children for corruption and greed. CNBC is still running made-for-TV segments about these villains. Bernie Madoff quickly became the villain of this crisis after it was revealed that his $50 billion hedge fund was nothing more than a Ponzi scheme. But his operation ultimately had little to do with the market crash and the media have had a difficult time pinning the excesses of AIG, Fannie Mae and Freddie Mac on single personalities. Unfortunately, the cronyism that has characterized this recession runs deeper than anything seen during the last recession.

The tech bubble burst in March 2000, bringing on a U.S. recession in early 2001 (according to the National Bureau of Economic Research). After the economic and psychological shock of September 11, the U.S. government made a big policy bet on financial services. The expansion of financial services was fueled by deregulation, loose monetary policy, asset securitization and the development of sophisticated derivative instruments. Policymakers heralded a new golden age of finance where risk was spread across the world. While the fundamental financial concepts that underlie these instruments (securitization and spreading of risk) are worth revisiting, the real life application of these theories has more to do with crony capitalism and the desire to generate huge profits for Wall Street with the blessing of Washington policymakers. From 1973 to 1985, the financial sector accounted for no more than 16% of domestic corporate profits. As the Glass-Steagall Act was repealed and financial deregulation gained steam, the financial sector garnered a larger share of domestic corporate profits, reaching 19% in 1986, reaching close to 30% in the nineties and crossing the 40% mark in the past decade, all on the back of massive leverage, creating massive fees and profits. Behemoths, like Citigroup and AIG, paid their financial superstars accordingly as the political weight of Wall Street reached levels not seen since JP Morgan consolidated the railroads and steel industries at the turn of the century and then bailed out the federal government in 1895 and 1907. The present day has seen the opposite occur as the "too big to fail" principle has Washington and Wall Street in lockstep, with billions of dollars being pumped into the financial sector to save the credibility of both politicians and bankers.

The financial sector, by no means, has a monopoly on lobbying and policy influence. The healthcare sector, automotive sector and military industrial complex have a strong presence in Washington, but it is the fluid movement of financial professionals into policy roles that is worth examining given the context of the current crash. During the Clinton years, Robert Rubin served as an economic policy assistant and later became the Treasury Secretary. Dubbed, "the greatest secretary of the Treasury since Alexander Hamilton" (Hamilton was the ultimate embodiment of the union of finance and politics) by President Clinton, Rubin, along with Alan Greenspan, strongly opposed the regulation of derivatives by the CFTC (Commodity and Futures Trading Commission) in 1997. In 1999, Rubin supported the largest financial deregulation bill in modern times, the Gramm-Leach-Bliley Act (it passed unanimously in the House and Senate, although it was introduced on the last day of Congress' session before the Christmas holiday), allowing the trading of credit default swaps (CDS) and providing financial firms the ability to consolidate investment and commercial banking under one roof with the added flexibility to dabble in insurance. The legislation was the final seal of approval for the Citigroup merger that created the currently beleaguered giant. Senator Phil Gramm later supported the passage of the Commodity Futures Modernization Act of 2000, which kept derivative transactions, including CDS, out of the purview of regulators. Unregulated, CDS contracts have played a major role in bringing down AIG and have forced other large banks to raise capital after making bad bets in an opaque marketplace. After his tenure as Treasury Secretary, Robert Rubin joined Citigroup in 1999 as a board member and served as a senor advisor for the company until his resignation in early 2009. While Citi's stock plummeted from over $50 in 2007 to below a dollar in 2009, Rubin collected millions in compensation. Phil Gramm currently works for UBS and was touted as a candidate for Treasury Secretary by John McCain during his 2008 presidential campaign.

Moving from one Treasury Secretary to another, Henry Paulson has more in common with Robert Rubin than just his cabinet position. Both Rubin and Paulson are former Goldman Sachs alum. Rubin became a General Partner in 1971 and served on the management committee with former U.S. senator and current Governor of New Jersey, John Corzine. Henry Paulson succeeded Corzine as chief executive when the firm went public in 1999. Corzine followed Stephen Friedman and Robert Rubin, all of whom have served in public policy positions. Corzine was integral in working with the Federal Reserve Bank of New York in orchestrating the Long Term Capital Management bailout in 1998. Friedman who sits on Goldman's board, was most recently the Chairman of the Federal Reserve Bank of New York before he resigned on May 7th of this year. During his tenure, Goldman received speedy approval for conversion to a bank holding company and a $10 billion capital injection in September 2008. Friedman had a large holding of Goldman shares which was in violation of Federal Reserve policy once Goldman became a bank holding company. While waiting for a waiver, Friedman continued to accumulate shares, buying an additional 37,300 shares in December. Friedman believed there was no conflict of interest and said he bought the shares because they were cheap. Friedman was also overlooking the search for a new Federal Reserve Bank President to replace the departing Timothy Geithner and was rumored to be favoring another former Goldman executive as his replacement.

Henry Paulson was front and center last fall when the U.S. stock market crashed. Most notably, Paulson was key in orchestrating the AIG bailout and was integral in the promotion of the TARP program to Congress. Both directives are ripe with conflicts of interest for Paulson as Goldman and Paulson stood to benefit from those plans. During the weekend of September 13th, when the New York Fed and Paulson were working on a bailout for AIG, the current CEO of Goldman Sachs, Lloyd Blankfein was also invited to attend. Perhaps he was there to offer some insight - it is more likely that he was there to make sure that the several billion that AIG owed Goldman would be taken care of. Furthermore, Edward Liddy, who was on the board of Goldman Sachs from 2003 to 2008, was brought in to run AIG in September while retaining his 27,129 share stake in Goldman Sachs. He was selected for both roles by none other than Henry Paulson. For the TARP program, which initially was intended to purchase bad debts from troubled banks but turned into a recapitalization vehicle, Paulson again went back to the Goldman alumni roster and chose Neel Kashkari. Prior to joining Paulson at the Treasury Department, Kashkari was a VP at Goldman Sachs in San Francisco. With all those Goldman alums in key policy positions, it's no wonder Goldman was in position to pay back the government funds it said it never needed last month and has been in a prime position to capitalize on the mistakes of its competitors. During the first 90 days of the year, the company had 34 days where daily proprietary trading gains exceeded $100 million. This was on top of 10 such days in December 2008. Good news for Goldman shareholders, but the fundamentals for other Wall Street banks remain weak. We could also dig deeper into the massive first quarter AIG windfall profits the major banks pocketed as AIG fire sold their positions, knowing their counterparties (Goldman was among them) would benefit at the expense of the taxpayer.

The personal connections between Wall Street and Washington are nothing new, but the blatant cronyism that is evident during the current crisis resembles the oligopolies of Russia and China more than the free market that is trumpeted by the likes of Larry Kudlow. International investors are well aware of the risks associated with investments in these countries and know it is better for their portfolios to invest with the oligarchs than against them. The lack of debate regarding the big government bet on financial services, much like the lack of serious debate on energy policy, has put the United States in a precarious position. The U.S. economy has become as dependent on financial companies as the

Russians have on energy and the Chinese on manufacturing. It is clear what the effects of a non-diversified economy have been on emerging countries. As the government continues to pump billions into the banking sector, essentially doubling down in gambling terms, it is evident that the end game will not be pretty. With so many conflicts of interest and incestuous relationships, it is hard not to be cynical when Congress talks about improving regulation of the financial giants. We're told that the correct balance must be struck between regulation and free markets at the present time because the economy needs banks to lend again. The recent rally will only stall much needed reforms and the likely outcome will be an outsourcing of regulatory policy reform to the bankers themselves, as has been done in the past. Better yet, the Federal Reserve, one of the most secretive institutions in the country, is the prime candidate for a wider regulatory role as the other regulatory bodies are mere paper tigers. The Fed may prove to be the best nominee despite fighting off Congress' demands for more oversight. Presently, Congress does not even have the right to audit the Federal Reserve. There is a greater likelihood that serious reforms will be stalled until the banking sector regains its strength. Democrats and Republicans alike are hoping they do as many have relied on big contributions from financial firms to fund their campaigns. Chris Dodd, Chairman of the U.S. Senate Committee on Banking, Housing and Urban Affairs and Barney Frank, Chairman of the House Financial Services Committee, will likely be in the media's crosshairs when they are up for election in 2010 due to their tangled relationships with Fannie Mae, Freddie Mac and Countrywide. They will not be alone as voters are likely to scrutinize Congress' ties to Wall Street and financial insiders more than in the past several elections. Despite the political fallout of the AIG bonuses, the top 10 recipients of federal bailout funds continued their fervent lobbying of Congress during the first quarter of the year.

The biggest fear for most of Congress may be losing their re-election battles but for most Americans the costs will prove to be greater. Most investors are still down more than 40% in their portfolios from the 2007 highs. While our focus is on absolute return strategies, the fundamentals, on which the traditional value investing mantra is based, are anything but clear when the government is so entangled in the banking sector. Furthermore, shareholders have no ability to influence change despite dismal performance by management, as was evident at the recent Citigroup shareholder meeting. The earnings outlook is murky at best and this is likely to remain a trader's market for quite some time.

The current rally has brought heightened levels of optimism, with many predicting economic growth before the end of the year. However, emerging from the current recession will only close a chapter of a larger crisis for the U.S. economy. The costs of bailing out the financial sector will be staggering. Swelling public debt and low interest rates will lead to higher inflation that will bring a day of reckoning for the U.S. dollar. To counter this spending, the U.S. must increase taxes and make difficult decisions on entitlement programs such as healthcare and social security. There inevitably will be less credit to finance imports, but the U.S. economy needs to become more diverse to increase exports and lower its trade deficit. If the economy is going to diversify away from financial services, the union between Washington and Wall Street must break down. Serious policy reforms are necessary so that the next banking crisis does not plunge the country into a deeper hole. The ship has been steadied but it would be naïve to believe that a financial oligopoly can continue to function in its current form. Massive government debt, a non-diversified economy, corporate cronyism and high inflation are all characteristic of failing emerging market economies that had to come hat in hand to the IMF for help. If the lessons of the current recession are not learned in the halls of Congress, the U.S. may soon face the same problems that have plagued Latin America, Eastern Europe and Asia in past crises. Hopefully, the insiders at the IMF will be willing to lend us a hand.