



# Strategy Overview

## The Crash of 2007/08 Act 2 Scene 1

Exit Bear, pursued by creditors

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# Meridian Investment Consultancy

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### The Crash of 2007/08: Act 2 Scene 1

"Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." Winston S. Churchill, 10 November 1942, after the battle of el Alamein.

#### **Update**

The big event of the first quarter of 2008 has been the collapse of Bear Stearns. From a share price of \$200 a year ago to \$10 as the final offer from JP Morgan is a long way to fall, but Bear Stearns had probably started the rot last June when it closed a couple of highly leveraged synthetic credit funds which had misjudged the US mortgage market.

I still treasure this email:

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**From:** Bear Stearns Capital Introduction Group (Exchange) [mailto:hedgefunds@bear.com]

**Sent:** 28 June 2007 13:45

**Subject:** BEAR STEARNS CAPITAL INTRODUCTION GROUP: INVESTOR EDUCATION EVENT: SYNTHETIC CREDIT - LONDON - MONDAY 9TH JULY 2007 - POSTPONEMENT

**\*\*\* POSTPONEMENT \*\*\***

**Please note that the Synthetic Credit Investor Education Event originally scheduled for 3:00pm, Monday 9 July, has been postponed.**

For more information regarding the Bear Stearns Capital Introduction Program, please contact . . . . .

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The Greeks said that "Those who the gods wish to destroy they first make mad". There's little doubt that all the banks have suffered a surfeit of *hubris*, and had come to believe in their own invincibility.

The big non-event of the quarter was the \$200 billion of additional liquidity added by major central banks on 11 March 2008. The S&P rallied 5% that day, but lost all the gain (and more) by the end of the week. There's no doubt that the extra liquidity helped, but the real problem is still the inability of banks to get to grips with the value of their assets.

The big development of the quarter was probably the acceptance that although the sub-prime problems are now well known, and fairly well quantified, the banks have much wider problems relation to poor lending practices in many other areas. The IMF has suggested that sub-prime losses could reach \$ 1 trillion, but a figure of that size is probably already discounted. It's the other areas of loss that are giving concern.

These include the so-called leveraged loans that have been used to finance private equity buy-outs, where the banks have been accepting discounts of 15% to 20% of face value to move them off their books.

But recently it's become quite quiet in financial markets. Volatility has dropped sharply, fewer rumours are circulating about imminent bank failures, and equity markets have mostly crept up. Even the Shanghai market has recovered a bit, after nearly halving in price from the beginning of 2008.

Food prices are a big concern in less developed countries.

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#### **Contagion – Hedge Funds**

The really surprising thing is that this didn't happen in August/September last year. Most of the serious problems which hit hedge funds as an asset class have started with liquidity problems. The LTCM crash of 1998 spread from Long Term Capital Management to most of the rest of the industry because sources of funding dried up. Only now have hedge funds started to show signs of problems. Since the middle of February 2008 we've seen one big hedge fund (Peloton) collapse, mostly because the ex-Goldman team running it decided too early that credit spreads had stopped widening, and started buying. The effects of their leverage and a misjudgement of the market was that the fund was wiped out in February, to the tune of \$2 billion.

Several other hedge funds have also closed in the last few weeks. Some of these claimed temporary liquidity difficulties, or a need to refinance their existing bank facilities. It's hard to see any banks rushing to help.

So far all our clients investing in hedge funds have been unscathed. Our approach to this market has always been that diversification was crucial, and that it was essential to hire asset managers who were expert in running portfolios of hedge funds, whether as a pooled fund or on a segregated basis. As part of our selection process we've always asked managers to look at a number of disaster scenarios (insurers will be familiar with these), and one scenario we've always used has been a liquidity crisis like the LTCM one in 1998.

Even so, we should assume that if these problems in hedge funds spread further there is a risk of losses affecting our clients. We've reviewed the present problems with all our managers, and at present we feel that all are prepared for things to get worse, and have positioned themselves well away from the main problem areas. So at present we're concerned, but not worried.

#### **Contagion – Other Funds**

The biggest casualty so far is not a hedge fund, but a leveraged bond fund run by Carlyle, a big private equity house. Worth \$17 billion in January it's now worthless.

There's a point of definition worth discussing here. The Carlyle bond fund has been referred to by some papers as a hedge fund. It was certainly a very expensive fund in terms of charges, but it wasn't something we'd recognize as a hedge fund. Just like the Bear Stearns mortgage funds, which collapsed in June last year, the Carlyle fund borrowed short to lend long, a classic recipe for disaster in a liquidity squeeze.

A similar casualty in February was Whistlejacket (who invents these names?), a structured investment vehicle (SIV) set up by Standard Chartered Bank. Whistlejacket had been set up to borrow in the asset-backed commercial paper market to invest in longer bonds, some of them, inevitably, turning out to be of dubious quality. Standard Chartered had been struggling for a while to keep the SIV afloat, but gave up in February as the assets continued to fall in value.

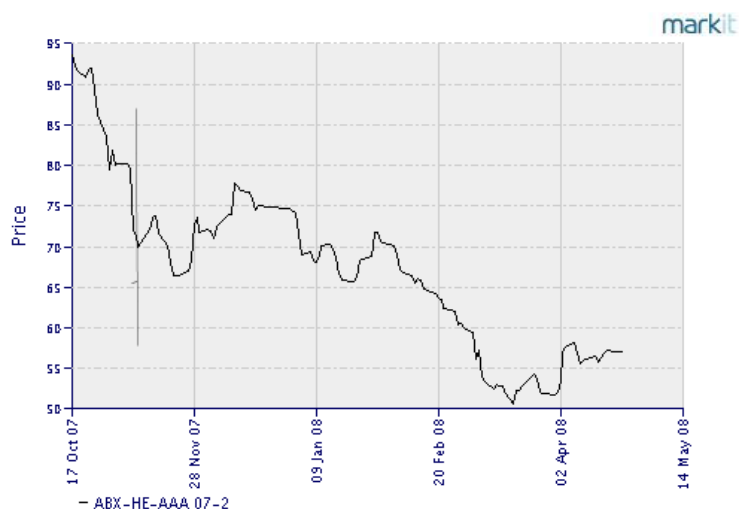
All the big banks have been working hard this year to prevent this happening to their own SIVs, either by buying assets from them, or by taking over the liabilities of the SIV entirely. There are big reputational issues here, and the banks have a difficult line to tread between taking more bad assets onto their balance sheets, or letting the SIV fail. This problem will continue to run.

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### **Continuing Collapse – Sub-prime**

In the second paper on the crash, published in November 2007, we used a couple of charts from <http://www.markit.com/information/products/category/indices/abx.html> which has some very useful charts, effectively of asset-backed bonds linked to mortgages. Here's an updated version of one of those charts:



The vertical line is the position in early November when we last published the chart. The index has lost almost as much since then as it had from inception to November, although there has been some recovery in April. The Markit indices aren't perfect, but they are a useful guide to what's happening.

In the real world of US housing prices it's pretty clear that values are falling, faster if anything. Estimates of losses to mortgage lenders have risen to \$400-500 billion, and the IMF are talking about a total cost of \$1 trillion.

### **Economic Outlook**

These reports haven't had much to say about economics recently. This is a very odd crisis, because we're used to the economy getting into difficulty, for whatever reason, and companies earning less, perhaps becoming bankrupt, and a credit crunch following as a result. This time things are the other way around. The credit crunch has come first, on a grand scale, and now we're beginning to see economic weakness, particularly in the middle ranks of UK high streets. Already Dolcis, Stead & Simpson, Elvi, Base Menswear and The Works have gone into administration, none of them large, but probably all featuring in a shopping centre near you.

The unwillingness of the banks to extend loans to anyone is clearly going to make this worse, not just in the UK but also in the US and several other European countries.

We shall only be certain about this in another three or six months, but we think it's sensible to assume that more bankruptcies are on the way, and that they'll get bigger as the recession deepens. If we're right then equity markets are looking very vulnerable.

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***Threat, or Opportunity?***

As Carlyle, Peleton and others have shown so well there's no point in buying too early, particularly on borrowed money.

However, for regular long-only investors all this doom and gloom has a sunny side. There will be opportunities to buy assets at yield spreads not seen since 2003. Not yet, for certain, but investment committees should start thinking now about how much more risk they will be prepared to take when the time is right.

We recommended most of our clients to halve their credit exposures last autumn. It's too early to start taking on more credit risk, but when good BBB corporate names already yield 3% more than the equivalent Treasuries there are clearly going to be some bargains to be had. We're not ready to start investing yet, but we do think that having the discussion now, and agreeing wider parameters to be used when the market turns, is a wise move.

At the next round of investment committee meetings, in late April and early May we'll be suggesting that our clients build a lot more flexibility into their credit restrictions so that when the time comes, perhaps in the second half of 2008, perhaps not until 2009, they'll have already taken the key decisions, and can move rapidly.

This is probably going to be particularly important in the US dollar market. If Fed Funds fall to 2% or lower (possibly to 1%), then earning an extra 3% on BBB bonds is going to look very tempting.

With some clients we'll also want to discuss other asset classes, including high yield bonds, emerging market debt, equities and UK commercial property. These won't suit everyone, but we think it's worth starting a discussion now, even if it takes six or twelve months to complete. There's no rush yet, and for some asset classes the time to buy may well be in 2009, not 2008.

When having these discussions we'll be careful to remember that insurers, just like Peleton, Whistlejacket and Carlyle, are effectively using money borrowed from policyholders. Insureds may not be able to ask for their cash back tomorrow, but catastrophe insurers need to be careful not to lend too long.

The key thing is to be patient, things are likely to get worse before they get better.

DWO

24 April 2008

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Earlier overviews can be found on our website:

<a href="http://www.mips.co.uk/doc/Crash1.pdf">http://www.mips.co.uk/doc/Crash1.pdf</a>	August 2007
<a href="http://www.mips.co.uk/doc/Crash2.pdf">http://www.mips.co.uk/doc/Crash2.pdf</a>	November 2007
<a href="http://www.mips.co.uk/doc/Crash3.pdf">http://www.mips.co.uk/doc/Crash3.pdf</a>	January 2008

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