

# STOCKBOY

Columbia Asset Management, L.L.C.

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## *Financial Institutions: Caveat Emptor!*

### **The Bounce-Back Bull**

As the 3<sup>rd</sup> quarter closed, the stock market was near another record high and one has to ask himself: what happened to the headline subprime mortgage and credit problems? It should still be an issue—it sent the market down 10%. Instead, all seems to be forgotten as if it occurred during the Fillmore administration.

That these credit problems could be forgotten so fast is disconcerting. Many of the issues that created that significant, though brief, unease are still in place. Is this stock market so focused on the ‘news of the week’ that what some hedge fund managers had called ‘the once in a lifetime perfect storm’ of stock market implosions in August is irrelevant by September?

Though this seems to be the case, I’d be wary. As Warren Buffett stated, the stock market is a weighing machine in the long run yet a voting machine in the short run. So even though many investors are ‘voting’ for a quick ‘bounce-back’ bull market, I’d suggest folks keep an eye out for more volatility to come. I’d say that the hurricane has perhaps not passed and that we’re being lulled by the eye of the storm (and that the 2<sup>nd</sup> half of the storm has yet to roll through).

I hope I’m wrong; and even if I’m right, I hope that the coming choppiness in the market is not even more severe than that we just experienced. I hope the weighing machine tells us the same thing the voting machine is.

### **Subprimes and Private Equity**

When one does focus on the subprime mess, the finger pointing is in full force—from the mortgage brokers, to the bankers, to Wall Street to the borrowers themselves.

The borrowers certainly must shoulder a good deal of the ‘blame’ as they either didn’t pay much attention to the potential downsides or assumed they wouldn’t be affected. However, I also firmly believe that the lenders were focusing on lining their own pockets and not loan suitability for clients regarding something that most see as their number one asset—their home. In the investment industry, advisors must follow the ‘Prudent Man

Rule’ where they put the needs of the client in front of their own. As a result, inappropriate investments, though they certainly occur, have not mushroomed like subprime loans, even during the dot-com craze (though the two certainly share similarities).

### **Private Equity—Surprise: big fees**

A recent article in the WSJ discussed private equity firms making more money from fees than from turning around the companies they acquire. This is only surprising in that it actually showed up in the headlines.

Private equity firms boast of their ability to turn around companies to the benefit of all involved, and sometimes this happens. However, what often takes place, particularly as the field has been quickly expanding, is that the private equity managers take out a lot of cash from the company and replace it with debt. This hurts the bondholders who then hold a more leveraged (read: financially weaker) company’s bond. And this is only profit #1 for the managers.

Of course, the goal of many private equity firms is to have their acquired companies go public again for a big payday, particularly in the current bull market. Profit #2.

Regardless of the success of the above two issues, private equity managers pay themselves quite handsomely during this process. What a surprise. It’s like Congress giving themselves a raise and improved retirement benefits.

Private equity is thus just another example of the excesses of Wall Street packaged in a form that seems desirable to investors.....at least initially.

Another troubling side-effect of this money grab is that many of our ‘best and brightest’ MBA students are going into private equity, investment banking and hedge funds. While these worthwhile industries can add value if properly managed, they shouldn’t be primary job sectors. They don’t really ‘make’ anything. They financially engineer things. There is typically no new tangible product—not a dish soap, sofa or car. Instead, it’s often morphing pile of money A into pile of money B while charging a big fee. When the best and brightest of a generation are financial engineers instead of real engineers, reality disconnects. It suggests an unrealistic bubble and perhaps a maturation of the U.S. economy. Let’s hope it doesn’t turn into an ossification.

### **Hey, Big Fees Here Too!**

Take the fund of funds concept for hedge funds. A fund of funds is, simply, a collection of hedge funds packaged together. As you may know, hedge funds typically charge 2% of assets (regardless of performance) and then 20% of profit. That’s a lot of fees. The fund of fund manager then comes in and often adds on charges of 1% of assets and 5-10% of profits. How the fund of funds can then pass on market-beating performance is hard to fathom.

As I mentioned in the last edition, hedge funds, on average, have rarely beaten the S&P 500. To justify their existence, one that makes them a huge amount of money and (perhaps sadly) acclaim, there is incentive for hedge fund managers to both take extra risk and paint as rosy a picture as possible.

When the credit market basically froze up in late summer, many hedge funds that had taken big bets on mortgage investments found themselves in difficulty. Even Goldman Sachs’ premiere Alpha hedge fund had reportedly lost 30% in about a month.

I can’t imagine most investors in Alpha were comfortable with that fall...or even thought it was a real possibility. Many hedge funds explained their problems by stating the ‘perfect storm’ hit or the one-in-10,000 event had occurred...so how could they be blamed?! Well, what just occurred in the credit market happened to the S&L’s in the ‘80’s and some foreign currencies in the 90’s. So, to say this type of event is highly rare is highly wrong.

Just because many institutions are falling too hard for these pitches doesn’t mean you need to. Just a year ago or so, Florida real estate was white hot, and now it’s cool...to ice cold. What investment will be the next over-hyped, speculative, talk of the cocktail party circuit? A bull market covers many sins. But a bear market, even if it’s short, can expose them. I see certain private equity and hedge fund investments potentially falling into this category.

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