Value Investing Congress
David Einhorn, Greenlight Capital, "Liquor before Beer… In the Clear"
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One of the nice aspects of trying to solve investment puzzles is recognizing that even though I am not always going to be right, I don't have to be. Decent portfolio management allows for some bad luck and some bad decisions. When something does go wrong, I like to think about the bad decisions and learn from them so that hopefully I don't repeat the same mistakes. This leaves me plenty of room to make fresh mistakes going forward. I'd like to start today by reviewing a bad decision I made and share with you what I've learned from that error and how I am attempting to apply the lessons to improve our funds' prospects.

At the May 2005 Ira Sohn Investment Research Conference in New York, I recommended MDC Holdings, a homebuilder, at $67 per share. Two months later MDC reached $89 a share, a nice quick return if you timed your sale perfectly. Then the stock collapsed with the rest of the sector. Some of my MDC analysis was correct: it was less risky than its peers and would hold-up better in a down cycle because it had less leverage and held less land. But this just meant that almost half a decade later, anyone who listened to me would have lost about forty percent of his investment, instead of the seventy percent that the homebuilding sector lost.

I want to revisit this because the loss was not bad luck; it was bad analysis. I down played the importance of what was then an ongoing housing bubble. On the very same day, at the very same conference, a more experienced and wiser investor, Stanley Druckenmiller, explained in gory detail the big picture problem the country faced from a growing housing bubble fueled by a growing debt bubble. At the time, I wondered whether even if he were correct, would it be possible to convert such big picture macro-thinking into successful portfolio management? I thought this was particularly tricky since getting both the timing of big macro changes as well as the market's recognition of them correct has proven at best a difficult proposition. Smart investors had been complaining about the housing bubble since at least 2001. I ignored Stan, rationalizing that even if he *were* right, there was no way to know *when* he would be right. This was an expensive error.

The lesson that I have learned is that it isn't reasonable to be agnostic about the big picture. For years I had believed that I didn't need to take a view on the market or the economy because I considered myself to be a "bottom up" investor. Having my eyes open to the big picture doesn't mean abandoning stock picking, but it does mean managing the long-short exposure ratio more actively, worrying about what may be brewing in certain industries, and when appropriate, buying some just-in-case insurance for foreseeable macro risks even if they are hard to time. In a few minutes, I will tell you what Greenlight has done along these lines.

But first, I'd like to explain what I see as the macro risks we face. To do that I need to digress into some political science. Please humor me since my mom and dad spent a lot of money so I could be a government major, the usefulness of which has not been apparent for some time.

Winston Churchill said that, “Democracy is the worst form of government except for all the others that have been tried from time to time.”

As I see it, there are two basic problems in how we have designed our government. The first is that officials favor policies with short-term impact over those in our long-term interest because they need to be popular while they are in office and they want to be re-elected. In recent times, opinion tracking polls, the immediate reactions of focus groups, the 24/7 news cycle, the constant campaign, and the moment-to-moment obsession with the Dow Jones Industrial Average have magnified the political pressures to favor short-term solutions. Earlier this year, the political topic *du jour* was to debate whether the stimulus was working, before it had even been spent.

Paul Volcker was an unusual public official because he was willing to make unpopular decisions in the early ’80s and was disliked at the time. History, though, judges him kindly for the era of prosperity that followed.

Presently, Ben Bernanke and Tim Geithner have become the quintessential short-term decision makers. They explicitly “do whatever it takes” to “solve one problem at a time” and deal with the unintended consequences later. It is too soon for history to evaluate their work, because there hasn’t been time for the unintended consequences of the “do whatever it takes” decision-making to materialize.

The second weakness in our government is “concentrated benefit versus diffuse harm” also known as the problem of special interests. Decision makers help small groups who care about narrow issues and whose “special interests” invest substantial resources to be better heard through lobbying, public relations and campaign support. The special interests benefit while the associated costs and consequences are spread broadly through the rest of the population. With individuals bearing a comparatively small extra burden, they are less motivated or able to fight in Washington.

In the context of the recent economic crisis, a highly motivated and organized banking lobby has demonstrated enormous influence. Bankers advance ideas like, “without banks, we would have no economy.” Of course, there was a public interest in protecting the guts of the system, but the ATMs could have continued working, even with forced debt-to-equity conversions that would not have required any public funds. Instead, our leaders responded by handing over hundreds of billions of taxpayer dollars to protect the speculative investments of bank shareholders and creditors. This has been particularly remarkable, considering that most agree that these same banks had an enormous role in creating this mess which has thrown millions out of their homes and jobs.

Like teenagers with their parents away, financial institutions threw a wild party that eventually tore-up the neighborhood. With their charge arrested and put in jail to detoxify, the supervisors were faced with a decision: Do we let the party goers learn a tough lesson or do we bail them out? Different parents with different philosophies might come to different decisions on this point. As you know our regulators went the bail-out route.

But then the question becomes, once you bail them out, what do you do to discipline the misbehavior? Our authorities have taken the response that kids will be kids. "What? You drank beer and then vodka. Are you kidding? Didn't I teach you, beer before liquor, never sicker, liquor before beer, in the clear! Now, get back out there and have a good time." And for the last few months we have seen the beginning of another party, which plays nicely toward government preferences for short-term favorable news-flow while satisfying the banking special interest. It has not done much to repair the damage to the neighborhood.

And the neighbors are angry, because at some level, Americans understand that the Washington-Wall Street relationship has rewarded the least deserving people and institutions at the expense of the prudent. They don't know the particulars or how to argue against the "without banks, we have no economy" demagogues. So, they fight healthcare reform, where they have enough personal experience to equip them to argue with Congressmen at town hall meetings. As I see it, the revolt over healthcare isn't really about healthcare, but represents a broader upset at Washington. The lack of trust over the inability to deal seriously with the party goers feeds the lack of trust over healthcare.

On the anniversary of Lehman's failure, President Obama gave a terrific speech. He said, "Those on Wall Street cannot resume taking risks without regard for the consequences, and expect that next time, American taxpayers will be there to break the fall." Later he advocated an end of "too big to fail." Then he added, "For a market to function, those who invest and lend in that market must believe that their money is actually at risk." These are good points that he should run by his policy team, because Secretary Geithner's reform proposal does exactly the opposite.

The financial reform on the table is analogous to our response to airline terrorism by frisking grandma and taking away everyone's shampoo, in that it gives the appearance of officially "doing something" and adds to our bureaucracy without really making anything safer.

With the ensuing government bailout, we have now institutionalized the idea of too-big-to-fail and insulated investors from risk.

The proper way to deal with too-big-to-fail, or too inter-connected to fail, is to make sure that no institution is too big or inter-connected to fail. The test ought to be that no institution should ever be of individual importance such that if we were faced with its demise the government would be forced to intervene. The real solution is to break up anything that fails that test.

The lesson of Lehman should not be that the government should have prevented its failure. The lesson of Lehman should be that Lehman should not have existed at a scale that allowed it to jeopardize the financial system. And the same logic applies to AIG, Fannie, Freddie, Bear Stearns, Citigroup and a couple dozen others.

Twenty-five years ago the government dismantled AT&T. Its break-up set forth decades of unbelievable progress in that industry. We can do that again here in the financial sector and we would achieve very positive social benefit with no cost that anyone can seem to explain.

The proposed reform takes us in the polar opposite direction. The cop-out response from Washington is that it isn't "practical." Our leaders are so influenced by the banking special interests that they would rather declare it "impractical" than roll up their sleeves and figure out how to get the job done.

The bailouts have installed a great deal of moral hazard, which in the absence of radical change will be reinforced and thereby grant every big institution a permanent "implicit" government backstop. This creates an enormous ongoing subsidy for the too-big-to-fails, as well as making it much harder for the non-too-big-to-fails to compete. In effect, we all continue to subsidize the big banks even though we keep hearing the worst of the crisis is behind us.

In addition, the now larger too-big-to-fails are beginning to take advantage of developing oligopolies. Even as the government spends trillions to subsidize mortgage rates, the resulting discount is not being passed to homeowners but is being kept by mortgage originators who are earning record profits per mortgage originated. Recently, Goldman upgraded Wells Fargo partly based on its ability to earn long-term oligopolistic mortgage origination spreads.

The proposed reform does not deal with the serious risks that the recent crisis exposed. Credit Default Swaps, which create large, correlated and asymmetric risks, scared the authorities into spending hundreds of billions of taxpayer money to prevent the speculators who made bad bets from having to pay.

CDS are also highly anti-social. Bondholders who also hold CDS make a bigger return when the issuing firms fail. As a result, holders of so-called "basis packages" – a bond and a CDS – have an incentive to use their position as bondholders to force bankruptcy triggering payment on their CDS, rather than negotiate traditional out of court restructurings or covenant amendments with troubled creditors. Press accounts have noted that this dynamic has contributed to the recent bankruptcies of Abitibi-Bowater, General Growth Properties, Six Flags and even General Motors. They are a pending problem in CIT's efforts to avoid bankruptcy.

The reform proposal to create a CDS clearing house does nothing more than maintain private profits and socialized risks by moving the counter-party risk from the private sector to a newly created too-big-to-fail entity. I think that trying to make safer CDS is like trying to make safer asbestos. How many real businesses have to fail before policy makers decide to simply ban them?

Similarly, the money markets were exposed as creating systemic risk during the crisis. Apparently, investors in these pools of lending assets that carry no reserve for loss expect to be shielded from losing money while earning a higher return than bank deposits or T-bills. Mr. Bernanke decided they needed to be bailed out to save the system. It is hard to imagine why this structure shouldn't be fixed, either by adding them to the FDIC insurance program and subjecting them to bank regulation, or at least forcing them to stop using $1 net-asset values, which gives their customers the impression that they can't fall in value.

The most constructive aspect of the Geithner reform plan is to separate banking from commerce. This would have the effect of forcing industrial companies to divest big finance subsidiaries, which would have to be regulated as banks. During the bubble, companies like GMAC, AIG Financial Products and GE Capital, with cheap funding supported by inaccurate credit ratings, took enormous unregulated risks. When the crisis hit, GMAC and AIG needed huge federal bailouts. The Federal Reserve set up the Commercial Paper Funding Facility to backstop GE Capital among others, and GE became the largest borrower under the FDIC's Temporary Liquidity Guarantee Program, even though prior to the crisis it wasn't even in the FDIC.

In response to the Geithner proposal, GE immediately let it be known that it had "talked to a number of people in Congress" and it should not have to separate its finance subsidiary because it disingenuously asserted that it hadn't contributed to the crisis. We will see whether the GE special interest is able to stave-off this constructive reform proposal.

Rather than deal with these simple problems with simple, obvious solutions, the official reform plans are complicated, convoluted and designed to only have the veneer of reform while mostly serving the special interests. The complications serve to reduce transparency, preventing the public at large from really seeing the overwhelming influence of the banks in shaping the new regulation.

In dealing with the continued weak economy, our leaders are so determined not to repeat the perceived mistakes of the 1930s that they are risking policies with possibly far worse consequences designed by the same people at the Fed who ran policy with the short-term view that asset bubbles don't matter because the fallout can be managed after they pop. That view created a disaster that required unprecedented intervention for which our leaders congratulated themselves for doing whatever it took to solve. With a sense of mission accomplished, the G-20 proclaimed "it worked."

We are now being told that the most important thing is to not remove the fiscal and monetary support too soon. Christine Romer, a top advisor to the President, argues that we made a great mistake by withdrawing stimulus in 1937.

Just to review, in 1934 GDP grew 17.0%, in 1935 it grew another 11.1%, and in 1936 it grew another 14.3%. Over the period unemployment fell by 30%. That is three years of progress. Apparently, even this would not have been enough to achieve what Larry Summers has called "exit velocity."

Imagine, in our modern market, where we now get economic data on practically a daily basis, living through three years of favorable economic reports and deciding that it would be "premature" to withdraw the stimulus.

An alternative lesson from the double dip the economy took in 1938 is that the GDP created by massive fiscal stimulus is artificial. So whenever it is eventually removed, there will be significant economic fall out. Our choice may be either to maintain large annual deficits until our creditors refuse to finance them or tolerate another leg down in our economy by accepting some measure of fiscal discipline.

This brings me to our present fiscal situation and the current investment puzzle.

Over the next decade the welfare states will come to face severe demographic problems. Baby Boomers have driven the U.S. economy since they were born. It is no coincidence that we experienced an economic boom between 1980 and 2000, as the Boomers reached their peak productive years. The Boomers are now reaching retirement. The Social Security and Medicare commitments to them are astronomical.

When the government calculates its debt and deficit it does so on a cash basis. This means that deficit accounting does not take into account the cost of future promises until the money goes out the door. According to shadowstats.com, if the federal government counted the cost of its future promises, the 2008 deficit was over $5 trillion and total obligations are over $60 trillion. And that was before the crisis.

Over the last couple of years we have adopted a policy of private profits and socialized risks. We are transferring many private obligations onto the national ledger. Although our leaders ought to make some serious choices, they appear too trapped in short-termism and special interests to make them. Taking no action is an action.

In the nearer-term the deficit on a cash basis is about $1.6 trillion or 11% of GDP. President Obama forecasts $1.4 trillion next year, and with an optimistic economic outlook, $9 trillion over the next decade. The American Enterprise Institute for Public Policy Research recently published a study that indicated that "by all relevant debt indicators, the U.S. fiscal scenario will soon approximate the economic scenario for countries on the verge of a sovereign debt default."

As we sit here today, the Federal Reserve is propping up the bond market, buying long-dated assets with printed money. It cannot turn around and sell what it has just bought.

There is a basic rule of liquidity. It isn't the same for everyone. If you own 10,000 shares of Greenlight Re, you have a liquid investment. However, if I own 5 million shares it is not liquid to me, because of both the size of the position and the signal my selling would send to the market. For this reason, the Fed cannot sell its Treasuries or Agencies without destroying the market. This means that it will be challenged to shrink the monetary base if inflation actually turns up.

Further, the Federal Open Market Committee members may not recognize inflation when they see it, as looking at inflation solely through the prices of goods and services, while ignoring asset inflation, can lead to a repeat of the last policy error of holding rates too low for too long.

At the same time, the Treasury has dramatically shortened the duration of the government debt. As a result, higher rates become a fiscal issue, not just a monetary one. The Fed could reach the point where it perceives doing whatever it takes requires it to become the buyer of Treasuries of first and last resort.

Japan appears even more vulnerable, because it is even more indebted and its poor demographics are a decade ahead of ours. Japan may already be past the point of no return. When a country cannot reduce its ratio of debt to GDP over *any* time horizon, it means it can only refinance, but can never repay its debts. Japan has about 190% debt-to-GDP financed at an average cost of less than 2%. Even with the benefit of cheap financing the Japanese deficit is expected to be 10% of GDP this year. At some point, as American homeowners with teaser interest rates have learned, when the market refuses to refinance at cheap rates, problems quickly emerge. Imagine the fiscal impact of the market resetting Japanese borrowing costs to 5%.

Over the last few years, Japanese savers have been willing to finance their government deficit. However, with Japan's population aging, it's likely that the domestic savers will begin using those savings to fund their retirements. The newly elected DPJ party that favors domestic consumption might speed up this development. Should the market re-price Japanese credit risk, it is hard to see how Japan could avoid a government default or hyperinflationary currency death spiral.

The failure of Lehman meant that barring extraordinary measures, Merrill Lynch, Morgan Stanley and Goldman Sachs would have failed as the credit market realized that if the government were willing to permit failures, then the cost of financing such institutions needed to be re-priced so as to invalidate their business models.

I believe there is a real possibility that the collapse of any of the major currencies could have a similar domino effect on re-assessing the credit risk of the other fiat currencies run by countries with structural deficits and large, unfunded commitments to aging populations.

I believe that the conventional view that government bonds should be "risk free" and tied to nominal GDP is at risk of changing. Periodically, high quality corporate bonds have traded at lower yields than sovereign debt. That could happen again.

And, of course, these structural risks are exacerbated by the continued presence of credit rating agencies that inspire false confidence with potentially catastrophic results by over-rating the sovereign debt of the largest countries. There is no reason to believe that the rating agencies will do a better job on sovereign risk than they have done on corporate or structured finance risks.

My firm recently met with a Moody's sovereign risk team covering twenty countries in Asia and the Middle East. They have only four professionals covering the entire region. Moody's does not have a long-term quantitative model that incorporates changes in the population, incomes, expected tax rates, and so forth. They use a short-term outlook – only 12-18 months – to analyze data to assess countries' abilities to finance themselves. Moody's makes five-year medium-term qualitative assessments for each country, but does not appear to do any long-term quantitative or critical work.

Their main role, again, appears to be to tell everyone that things are fine, until a real crisis emerges at which point they will pile-on credit downgrades at the least opportune moment, making a difficult situation even more difficult for the authorities to manage.

I can just envision a future Congressional Hearing so elected officials can blame the rating agencies for blowing it, as the rating agencies respond by blaming Congress.

Now, the question for us as investors is how to manage some of these possible risks. Four years ago I spoke at this conference and said that I favored my Grandma Cookie's investment style of investing in stocks like Nike, IBM, McDonalds and Walgreens over my Grandpa Ben's style of buying gold bullion and gold stocks. He feared the economic ruin of our country through a paper money and deficit driven hyper inflation. I explained how Grandma Cookie had been right for the last thirty years and would probably be right for the next thirty as well. I subscribed to Warren Buffett's old criticism that gold just sits there with no yield and viewed gold's long-term value as difficult to assess.

However, the recent crisis has changed my view. The question can be flipped: how does one know what the dollar is worth given that dollars can be created out of thin air or dropped from helicopters? Just because something hasn't happened, doesn't mean it won't. Yes, we should continue to buy stocks in great companies, but there is room for Grandpa Ben's view as well.

I have seen many people debate whether gold is a bet on inflation or deflation. As I see it, it is neither. Gold does well when monetary and fiscal policies are poor and does poorly when they appear sensible. Gold did very well during the Great Depression when FDR debased the currency. It did well again in the money printing 1970s, but collapsed in response to Paul Volcker's austerity. It ultimately made a bottom around 2001 when the excitement about our future budget surpluses peaked.

Prospectively, gold should do fine unless our leaders implement much greater fiscal and monetary restraint than appears likely. Of course, gold should do very well if there is a sovereign debt default or currency crisis.

A few weeks ago, the Office of Inspector General called out the Treasury Department for misrepresenting the position of the banks last fall. The Treasury's response was an unapologetic expression that amounted to saying that at that point "doing whatever it takes" meant pulling a Colonel Jessup: "YOU CAN'T HANDLE THE TRUTH!" At least we know what we are dealing with.

When I watch Chairman Bernanke, Secretary Geithner and Mr. Summers on TV, read speeches written by the Fed Governors, observe the "stimulus" black hole, and think about our short-termism and lack of fiscal discipline and political will, my instinct is to want to short the dollar. But then I look at the other major currencies. The Euro, the Yen, and the British Pound might be worse. So, I conclude that picking one these currencies is like choosing my favorite dental procedure. And I decide holding gold is better than holding cash, especially now, where both earn no yield.

Along these same lines, we have bought long-dated options on much higher U.S. and Japanese interest rates. The options in Japan are particularly cheap because the historical volatility is so low. I prefer options to simply shorting government bonds, because there remains a possibility of a further government bond rally in response to the economy rolling over again. With options, I can clearly limit how much I am willing to lose, while creating a lot of leverage to a possible rate spiral.

For years, the discussion has been that our deficit spending will pass the costs onto "our grandchildren." I believe that this is no longer the case and that the consequences will be seen during the lifetime of the leaders who have pursued short-term popularity over our solvency. The recent economic crisis and our response has brought forward the eventual reconciliation into a window that is near enough that it makes sense for investors to buy some insurance to protect themselves from a possible systemic event. To slightly modify Alexis de Tocqueville: Events can move from the impossible to the inevitable without ever stopping at the probable.

As investors, we can't change the course of events, but we can attempt to protect capital in the face of foreseeable risks.

Of course, just like MDC, there remains the possibility that I am completely wrong. And, personally, I hope I am. I wonder what Stan Druckenmiller thinks.

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