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FINANCIAL ADVISOR

Knowledge for the Sophisticated Advisor
March 2008

A Better Way

Spire Investment Partners is attracting far-flung groups of breakaway brokers to the advisory firm.

From left: Larry Gaffey, David Blisk and Phillip Fournier

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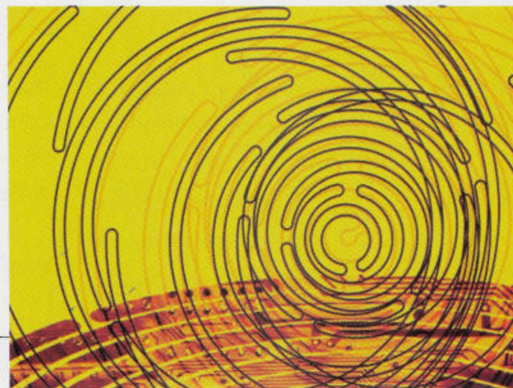
› BY STEVEN HOLT ABERNATHY



Overcoming The Leveraged Fallout

Know your holdings; don't fear volatility.

Ever since the Great Depression, the Federal Reserve has been in charge of creating money supply. When the economy is threatened with recession, the Fed shovels money into the system, where consumers spend it to buy everything from groceries to automobiles, creating jobs. When the economy overheats, the Fed shrinks the money supply to retard inflation.

But there's been a systemic change over the past couple of decades. Gradually, the Fed has redirected the money to the major financial institutions, which have become the new CEOs of the nation's capital allocation. The large financial institutions have used their newfound status to create products that employ extensive and reckless borrowing (leverage). In many cases, they have simply shifted the leverage to a third party, washing their hands. Over the years, this strategy has been honed, remodeled and re-engineered until the market has been flooded with exotic products whose value and behavior are cloudy at best.

Today, control over the economy is in the hands of Wall Street bankers who have created so much leverage, even they don't have a handle on the amount or its potential impact. Previously, when the Fed put a dollar into the economy, it ended up being eight to ten dollars by the time it wiggled its way through the economy and back to the Fed itself. Today, a dollar injected into the economy in the form of CDOs, SIVs and similar products is leveraged into $50 to $100.

As a result, financial advisors may have clients invested in products and vehicles with significant exposure to this house of cards. While many outcomes are possible, and no one can tell how things will turn out, it's possible that the recent wave of money market funds closing, hedge funds collapsing and banks taking enormous write-offs is just the beginning. Just how deep does this rabbit hole go?

Ominous Trends

Consider the growth of leverage in private equity over just the past five years. Back in 2002, a private equity firm typically would leverage investor money to borrow five or ten times the amount to buy a company. At year's end 2002, private equity had about $51 billion in leverage. In the five years since, that amount has soared to $300 billion, with another $300+ billion scheduled to close by the end of Q1, 2008. Unless something significantly changes, the private equity market will have grown from $51 billion in 2002 to about $650 billion in just five years.

Over the same five-year period, individual borrowings for stock purchases—margin accounts—have grown $134 billion to $293 billion. Hedge funds, the new iterations that have blossomed over the past 20 years, were originally designed to be risk-lowering plays. However, most have been recast as risk-leverage plays. In 2002, hedge fund borrowings that could be identified were $177 billion (about half the hedge funds aren't registered with the SEC). By the beginning of 2007, that amount had grown eightfold to $1.4 trillion, not including the amount that is untraceable.

Add to this the borrowings by brokerage firms: $4.9 trillion currently, up from $1.8 trillion on their books as of 2002.

Adding up the leverage carnage:

Private equity	$650 billion
Margin accounts	$293 billion
Hedge funds	$1.4 trillion
Brokerage firms	$4.9 trillion

The total is over $7 trillion, a frightening number indeed. And this does not take into account all the unregistered derivatives floating around out there, which could well represent ten times the amount of registered product. Globally, some count $480 trillion in outstanding notional derivatives!

Here's another scary thought: The originators of the products being used as leverage—the people who sit on the trading desks and originate the derivatives—have virtually no idea as to the extent of their exposure. It's impossible to predict which butterfly flutter could tip us into a steep recession—or worse.

I don't want to be the predictor of doom and gloom; hopefully, the markets will remain rational and not roll over. But if the war escalates, a couple of big hedge funds or banks implode, or if the Street banker/brokers finally come clean and tell us the scope of what is floating around out there in Level 3 exposure, we could see the abandonment of the dollar and a challenge to the existing financial system.

Keeping Your Clients Calm (And Their Capital Safe)

The source of most investors' emotional insecurity is a lack of information—and investors are insecure for a good reason. They don't know much about their investments. Some equity holdings have dangerous, unexpected exposure to this crisis. After rigorous analysis, others turn out to have none. Do you as an individual or as a fiduciary know as much about your holdings as you'd like?

Of the stocks you hold, do you know what each division in that company does? Do you know what their tangible assets are worth in comparison to their trading price? What about the company's value to a competitor prowling for an acquisition?

Does the company pay a dividend? If so, how much will its profits have to drop before it has to cut the dividend? How much cash does the company have on its balance sheet? How is the CEO

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compensated? Is the management's compensation aligned with your goals as an investor? What about the sales force? What will the company's cash flow generation be in 2007 or 2008? What are the changes taking place at the company and at rival companies? What are the greatest risks to the company—now and over the next five years? What will the company likely look like in five years? Why did you invest in the company in the first place? Did you record your reasons for investing? Have your reasons for owning the company changed?

Most investors lack answers to these questions. Those who invest in mutual funds or alternatives don't get off any easier: The same questions apply to whatever the funds hold.

To safeguard your clients' capital during these times and to give them a sense of long-term calm, consider the following:

- **Know what you own.** Clients should invest with a definable margin of safety. You must be able to accurately value a company, its assets and liabilities, and understand the probable future cash flows. If you don't have the resources for this kind of exhaustive analysis—and many financial advisors don't—work with money managers who do.
- **Don't let the turmoil trick your clients into selling solid securities.** The credit crisis may affect companies that borrow heavily; look for companies that don't require new financing to continue their operations and grow. Record your reasons for making each investment.
- **Don't fear volatility.** When everyday investors panic and markets fall uniformly, it is a tremendous opportunity to buy quality companies at a discounted price. In these times, the price performance of a stock is often unrelated to the company's intrinsic value. Put your trust in managers who analyze companies deeply and regularly meet with company management. Volatility can be a friend if you buy when others are fearful—and sell when they are greedy.
- **Own quality companies that have a margin of safety with some growth potential.** Companies must be able to self-fund growth, have an identifiable and well-regarded "brand," offer visibility into future cash flow and be able to grow.
- **While many stocks appear expensive, some are not,** in particular those benefiting from the export markets. Keep some cash on hand for bargains.

Once the carnage is over and we finally ascertain where the leverage is buried and how deep, punishment will be harsh for those who drank the Kool-Aid. Yet, having learned an important lesson, the cleansed markets will offer a solid investment environment for well-run companies with solid balance sheets that create value for shareholders. Lest we forget, Wall Street will continue to invent esoteric products to separate investors from their money. In other words, wash, rinse and repeat. ◎

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