

Mark to Madness

Never in a hundred years did we think we would write a newsletter about accounting. Never in a thousand years did we think we would choose to write such a letter in the midst of a financial crisis - but an accounting principle is a key to understanding the crisis.

Imagine you are with a friend; his phone rings and he is told that he is getting a margin call on his house, which needs to be sold in the next 24 hours. He hurriedly starts calling realtors and friends with ready cash. Assume the “real” value of his house is \$800,000 - will he be able to get even \$100,000 in the next 24 hours? Let’s say he gets lucky and does. While you ponder his plight, your phone rings. Your friend’s house sale at \$100,000 has set the new market price and triggered a margin call on your home; you also have 24 hours sell. You might even get less for your house than your friend, relative to its real value, and your sale, in turn, may result in margin calls to your neighbors.

What, after all, is a market price? If you want to sell 100 shares of IBM stock, you will likely get something close to the price you pull up on Yahoo! Finance. If you want to sell five million shares, you will not. Market prices are not a number in isolation, but the result of a set of circumstances - the timeframe for the sale, the size of the sale relative to the liquidity of the market and the asset’s complexity. In our example, your friend likely would get a much higher price for his house if he had a week or a month to complete the sale, although the price probably would still be below the true value. If he had six months, he might get something approaching the true value (although things might get interesting again in the final days before the deadline).

Our example of the margin call on your friend’s house sounds strange because, on your personal balance sheet, a house is not a “mark to market” but a historical cost asset. If your house value falls below your mortgage balance, nobody will bother you as long as you continue to make the mortgage payments. Stocks *are* marked to market, and a severe decline in stocks you bought with money borrowed from a broker will result in a margin call. Which assets are marked to market is simply a matter of accounting convention. The line can be blurry, though, and may depend on how easy it is to determine values. A public stock is marked to market, while a venture capital firm usually assumes that the market value of its portfolio companies is its cost until

something happens (e.g. the portfolio company going public or going bankrupt) that makes a different value clear.

Buyers of assets that are not marked to market may have the potential to use substantial leverage, because of the perceived “stability” (or willful ignorance) of the current value. Margin leverage if you buy a public stock is limited to two to one; if you buy a house, your leverage might be 10 to 1; if you do a leveraged buyout of a company, your leverage might be 20 to 1. Leon Cooperman, then a Goldman Sachs partner, once figured that owning a diversified list of public stocks with the same leverage as one of the star managers of the private equity/leveraged buyout world during the 1980s would have produced profits exceeding, by a significant amount, those of the private equity firm. In other words, the value of the much-vaunted managerial brilliance of the buyout firm was a negative number – they just had the good fortune to be able to use tremendous leverage in a huge bull market.

“To say accounting for derivatives ... is a sewer is an insult to sewage.”

– Charles Munger

Much of the recent financial crisis is the result of an inability to reasonably value derivative securities with no ready, liquid trading market. Through the alchemy of securitization, Wall Street took the prosaic home mortgage and transformed it into an astonishing array of different securities with no prices available on Yahoo! Finance. The investment banks and hedge funds holding these securities, often employing shocking amounts of leverage, valued them according to quantitative models. Like the example of your friend’s house, though, when one holder has to sell and receives something far below what the pricing models would predict, it can trigger margin calls and a cascade of forced selling. Many derivative securities lacked both simplicity and liquidity. In one memorable weekend among many in the recent credit crisis, our government asked Goldman Sachs and Morgan Stanley to take over AIG, with its intricate mix of subsidiary businesses and complex book of illiquid derivatives contracts, on 24 hours notice. The two investment banks, under considerable market pressures themselves, demurred – without being able to analyze and understand AIG’s books (something that would probably take weeks, or longer), they would be buying a pig in a poke.

One of the great features of capitalism is the flow of information contained in “market” prices and the accompanying discipline of the free market. If you need to remove a bandage, it is usually best to rip it off fast, confronting the reality of the likely pain. In the Japanese banking crisis in the 1990s, policy makers decided to rip the bandage off slowly, encouraging a denial of the reality of bad loans, and a 15-year depression followed. On the other hand, daily mark-to-market accounting for leveraged, complex, illiquid assets is akin to ripping off the bandage constantly without giving the wound a chance to heal. The policy challenge is to maintain the historical vitality of a true capitalist system while allowing healing to occur. A step forward would be to make complex assets simple – e.g., standardizing derivatives that trade publicly and settle through a central clearinghouse, just like options and futures.

The current financial panic will subside, markets will recover and, like the swallows to Capistrano, financial engineers will once again return to their product creation alchemy. What you need are liquid trading markets establishing real values for assets and an investment manager that can discern their utility or risks to your portfolio. If you have any questions or concerns about what is going on in the markets, please contact us at (503) 419-3938 or www.sigmainvestment.com.