

October 2008

## Unintended Consequences

### ***Snowball release***

Alice Schroeder has written a long anticipated biography about Warren Buffett. She has spent several years researching the book, with access to Berkshire Hathaway records that has been denied to others. (As a side note, she spoke at the first ERM Symposium and I tried to engage her, unfortunately to no avail, about Berkshire) While excerpts have focused on his relationship with his first wife and why/whether she left him many years ago, the real nuggets of wisdom will come if she is able to explain opportunities that Buffett and Charlie Munger passed on and why. It will be interesting to hear Schroeder's reporting of the Gen Re court case regarding AIG and the use of finite reinsurance. She took the witness stand as part of that trial in the middle of the research for this book.

There are two specific questions that I would ask Warren if I could, and as that is unlikely I am hoping that Schroeder will provide the answers.

1. **Taxes:** Buffett and Munger both ran limited partnerships in the 1950s. These would be called hedge funds today. My understanding is that they were paid by allocating some of the partners' returns if those returns were higher than a benchmark, reported to have been 6%. Did WEB pay taxes on this income as it was earned, or was he able to defer it? Buffett has been very vocal about the need for "rich" people to pay an estate tax when they die, although he personally is avoiding it by giving the money to charitable organizations (some of which pay his children a salary). But the argument many, including me, make about not paying an estate tax is that we have already paid income tax on these earnings and that it is double taxation. While Buffett lectures us about tax policy, has he used the details of the tax law to avoid most personal taxes over his lifetime?
2. **Malthus:** When I first started attending Berkshire Hathaway meetings in the mid 1990s, the primary demonstrators were pro-life supporters uncomfortable with Buffett's personal support of initiatives related to population control. I heard him talk about the ultimate shortfall of food supply relative to the number of bodies at one meeting. As an aside, it is thought that overpopulation, especially an overabundance of young males, will lead to social unrest and wars as groups of people need food and resources to keep from starving (note China's one child policy and the large number under the age of 20 in many Middle Eastern and Asian countries). Since his wife Susan died, he has pledged much of his wealth to the Gates Foundation, whose goals seem to be the polar opposite. By focusing on diseases such as malaria, which kill so many needlessly, and providing both research and cheap solutions to sanitation and other problems of overcrowding, the Gates' are arguably fueling this phenomenon. Talk about your unintended consequences. Why the conversion?

In a future newsletter, once I have read the book, I will share my thoughts. I have been looking forward to reading it for quite a while, and hope not to be disappointed.

## ***Financial Services Bailout***

I had planned to write just a short newsletter this month, but the financial markets have been so active and bizarre that I feel the need to do a quick brain dump. Since it's likely the crisis is not done, here is the time stamp. Bear Stearns went down earlier this year, and recently Washington Mutual (a former personal holding), AIG, and Lehman Brothers have been allowed to go under while others have been propped up. After the first draft Wachovia went down and the initial bailout vote failed, resulting in a large market correction. I have one client who has said that all insurance insolvencies have been driven by liabilities. He makes a good point. By this he means that companies are under pressure to earn more on their assets due to competitive pressures to increase credited rates or lower premiums. With AIG being taken down by a division that wrote credit default swaps, often on CDO tranches, and had no liabilities this statement is no longer true.

Over the past 10 years or so, the Federal Reserve has bailed out the economy each time it tried to slow down by lowering the borrowing rate or increasing the money in circulation. Some even think that government now has the tools to forever avoid recessions. Unfortunately it is human nature to take more risks until something bad actually happens. Now the US Congress is preparing a bailout plan for owners of securitized residential mortgages. Many banks are hamstrung because their balance sheet is full of them and they are not performing as expected. Of course, if investors had taken the time to understand what types of mortgages were included in these packages, perhaps they are performing as expected. Sub-prime mortgages are now expected to pay off only 50% of the time. But that is another newsletter.

Every action taken by government leads to consequences for the economy. While the goals are admirable and, especially in an election year, there were politics involved, what are some potential unintended consequences of their actions? Note that it could take several years for these ramifications to play out (recall that guns and butter spending in the 1960s did not cause inflation until the oil shocks of the 1970s).

Here are some economic variables where I expect adverse consequences from current economic policies.

- Inflation will rise – more money in the system requires higher prices
- Dollar deflation
- Energy prices up
- Food prices up

These are really all the same phenomenon. If you print more money and there are not additional products or services, prices go up eventually. The budget deficit is high. The trade deficit is high. There are no bullets left in the gun. Other unintended consequences will follow. Perhaps I will discuss more of them in my Financial Predictions for 2009.

## ***Counterparty Risk***

When the government declares a company insolvent and wipes out the shareholders, but then declares that that counterparty risk is so large for the system that it must provide

support, how is the appropriate counterparty risk being charged? Buffett, among others, has stated for a long time that the counterparty risk of derivatives was much too concentrated among just a few firms. Clearly he was right, but the buyers of credit default swaps are not being forced to account for this. The price charged should have been lower for the CDS because of the possibility that the counterparty would not pay. When, at the end of the day, the government makes sure this counterparty is whole and available, the market becomes unbalanced.

### **Leverage**

Leverage is another missing element in these discussions. Investment banks were not required to put up collateral until the death spiral had begun. It is unclear to me how insurance Risk Based Capital handles CDS with a formula based rule. Switching them over to Basel requirements would be a good thing, as long as they are not able to trick themselves again into thinking that these risks are all independent and modelable. Many of these firms, such as AIG, seem to not understand the difference between dependency and correlation. Correlation is a historical measure that shows how 2 risks have moved in the past. Dependency is a future metric. Will a specific risk drive the results of another specific risk? Contagion is rarely covered by correlation. Intuition and business sense should override models in a distribution's tail when it comes to dependency.

### **Bank Contagion**

One issue that came out recently was how many small and mid-sized banks held Fannie Mae and Freddie Mac stock. I'm sure they thought these were safe since they were government sponsored entities and backed by the government. What they did not know was that the government would bail out those who hold the counterparty risk but not the equity risk. The group we have not heard from is the group of Federal Home Loan Banks. How are they doing? Are they experiencing a run on the bank from institutional investors who have lines of credit set up with them? Are they financially secure?

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