

# FINANCIAL CRISIS TO WORLD- WIDE DEPRESSION

HOW DID WE GET THERE AND WHAT SHOULD WE DO?

*17<sup>th</sup> Forbes Cruise for Investors*

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# The Crash of 2008 - 2009 Compared to 1929

- **The 1929 Crash did not cause the Great Depression.**
  - Only 3% of Americans owned stock at that time.
- **The 2008 - 2009 Crash caused the steepest recession since the Great Depression.**
  - The Crash was conceived, engineered and marketed through Wall Street instruments and sold to investors both in the US and Globally.
  - Congress and several Administrations made serious policy errors, that make Herbert Hoover's economic advisors almost look like superstars next to Bernanke, Paulson, Geithner and Summers.
- **To Begin**

# The Breakdown of Regulation, Financial and Risk Analysis that Led to the Panic

- **Weakening of the Financial System during Clinton Administration:**
  - Barney Frank and Democrats pushed for low cost housing, pressuring Fannie, Freddie and Banks for more lower-income loans. Higher risk not focused on.
  - Larry Summers, Clinton's last Secretary of the Treasury, played a major role in repealing the Glass-Steagall Act – which allowed banks to make riskier investments.
- **Greenspan, followed by Bernanke, kept interest rates far too low after the 2000-2002 Dot Com Bubble.**
- **Low rates resulted in excessive risk taking by banks, investment banks, mortgage companies, and private equity funds.**

# The Breakdown of Regulation, Financial and Risk Analysis that Led to the Panic

- **The Bush Administration accelerated the course by pressuring Fannie et al. to extend mortgages to poor quality borrowers.**
- **New financial instruments introduced that made the transfer of complex mortgages appear simple including:**
  - Structured Financial Vehicles (SFVs)
  - Collateralized Debt Obligations (CDOs)
  - Mortgage-Backed Securities (MBS).
- **Advanced computer programming played a major role designing these securities. The statistics behind the complex modeling were seriously flawed, leading to disaster by 2005-2006.**
- **The modeling was based on EMH theory, that believed that liquidity was always available. This serious academic flaw was responsible for the 1987 Crash, the Long-term Capital Debacle, and the 1988 High Yield Crash.**

# The Enormous Expansion of CDO's and Sub-Prime Lending

\$ Million Year	High Yield Loans	Investment Grade Bonds	Structured Finance	Total
2000	22,714.5	29,891.9	1,038.3	67,987.7
2001	27,368.2	31,959.2	793.9	78,453.8
2002	30,387.8	21,452.7	17,499.2	83,074.2
2003	22,583.8	11,770.1	35,106.2	86,629.8
2004	32,192.2	11,605.7	83,261.5	157,820.7
2005	69,441.2	3,877.8	157,572.2	251,265.3
2006	171,905.9	24,864.5	307,704.9	520,644.6
2007	138,826.6	78,571.1	259,183.6	481,600.7
2008	27,489.4	15,955.2	18,442.2	61,886.8
2009	2,032.7	1,890.5	281.2	4,204.4

Percent % Year	High Yield Loans	Investment Grade Bonds	Structured Finance	Total
2000	33%	44%	2%	100%
2001	35%	41%	1%	100%
2002	37%	26%	21%	100%
2003	26%	14%	41%	100%
2004	20%	7%	53%	100%
2005	28%	2%	63%	100%
2006	33%	5%	59%	100%
2007	29%	16%	54%	100%
2008	44%	26%	30%	100%
2009	48%	45%	7%	100%

Total also includes High yield bonds, mixed collateral, other swaps, other.

Source: SIFMA: Securities Industry and Financial Markets Association

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# The Pillage of Sub-Prime Buyers

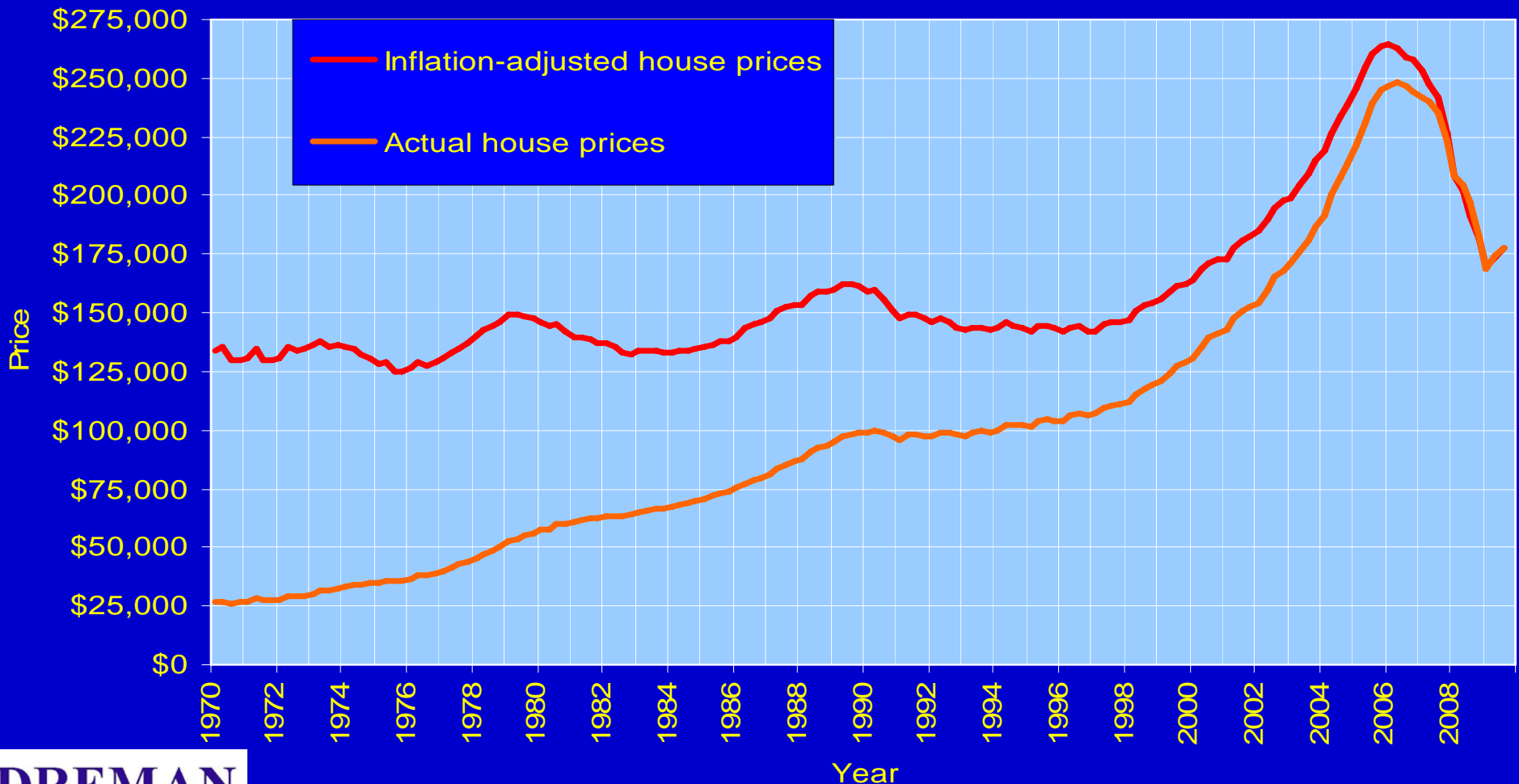
- Sub-prime mortgage salesman made used car sellers look like Bible marketers. Congressional and State investigations since 2004.
- Over 60% of sub-prime buyers qualified for prime rate mortgages with interest rates 3% lower.
- Major pre-payment penalties.
- Mortgage seller demanded only 2% teaser rate -- not actual rate of 8-11%. Virtually no buyers could afford actual rates.
- Mortgagees were asked for no or minimal paperwork and sellers often falsified the applicants' figures.
- 25% of some mortgage sellers income came from late payment fees.

# Sub-Prime: The Largest Bubble in History

- **CDO, SIV and MBS rose to three trillion dollars from 2002-2005. The large proportion were issued in 2005-2006 to mid 2007. Home prices were already falling by 2006.**
- **A good portion of the mortgages were sub-prime or Alt-A with packaging of thousands of mortgages of different grades making value difficult to determine even in boom times.**
- **Ratings Agencies worked closely with the Underwriters and received large up-front fees for providing AAA, AA, and other high ratings to securities that turned out to be junk. Rating Agencies systems proved to be far too optimistic.**
- **The CDO and SIV structures were very complicated and liquidity even in the boom times was almost minimal.**
- **The business of selling CDO's and Sub-primes was extremely profitable. Banks bought up dozens of mortgage companies as well as creating their own. Institutional holdings were in the trillions.**

# Housing was a Guilt-Edged Investment: Mortgagers Believed Prices Never Fell in Actual Terms

## United States House Prices



**With Such High Returns**

***“Bankers Never Looked Under the Hood”***

**Major Institutions Oblivious to  
Enormous Risk**

# S&P/Case-Shiller Home Price Indices: The Devastating effects of Financial Leverage

- From its peak in May 2006, the Case-Shiller Home Price Index of 20-Cities has dropped 32%. Las Vegas, Miami, Phoenix, Detroit, San Francisco and San Diego posted drops greater than 40%.

<b>% Drop in Housing Prices</b>	<b>Drop in Initial Equity assuming 35:1 leverage</b>
<b>2.86%</b>	<b>-100%</b>
<b>5%</b>	<b>-175%</b>
<b>10%</b>	<b>-350%</b>
<b>15%</b>	<b>-525%</b>
<b>20%</b>	<b>-700%</b>
<b>30%</b>	<b>-1050%</b>
<b>40%</b>	<b>-1400%</b>

# Precursor to the Crash:

- **March 2008 – Bear Stearns levered 33 : 1**
- **Investment grade mortgage index plummets.**
- **At the eleventh hour (under the auspices of the NY Fed) J.P. Morgan buys Bear Stearns at \$10/share.**
- **Fed guarantees \$28 Billion of Bear Stearns bad debt**
  - because of the interconnectivity of the financial industry, bankers agreed there was no choice.

# Panic and Crash: Fall of a Mortgage Investment Grade Index



# The Beginnings of the Panic:

- **The Fed under Bernanke and the Treasury under Paulson**
  - Reassuring statements were made in mid-2007 that the mortgage crisis would not effect the economy.
- **The lethal influence of the short-seller**
  - The up-tick rule which was put in place after the 1929 crash was removed in 2007.

# Panic and Crash: Bear Stearns Aftermath

- **Fed and Treasury remain asleep at the switch**
  - No preparation is taken for the financial tsunami that is approaching.
- **Housing prices continue to fall as increasing numbers of Alt-A and subprime mortgages default.**
- **Banks, brokerage houses, REITs and other owners of mortgage securities begin to sharply increase reserves.**
- **Reserves not large enough to see these institutions through the Crisis.**
- **Financial institutions become unglued.**

# The Crash: Panic Engulfs Investors

- **Fannie and Freddie guaranteed nearly half the home mortgages across the country.**
  - Foreign governments that hold Fannie and Freddie paper begin to panic (particularly China and Japan).
  - June 2008 – Treasury Secretary Paulson announces that both institutions will be granted borrowings from the Fed.
- **September 8, 2008 - Paulson and Lockhart make an unexpected 180° shift in policy.**
- **GSE's are placed under conservatorship.**
- **Both preferred and common shares drop over 90%.**

# Panic and Crash: Sept. – Oct. 2008

## Aftermath of Freddie and Fannie

- **September 15:** Lehman files Chapter 11, Bank of America buys Merrill Lynch, and AIG seeks support from the Federal Reserve; Primary Reserve Fund Breaks the Buck.
- **September 16:** The Federal Reserve authorizes the Federal Reserve Bank of New York to loan \$85 billion to AIG, the U.S. government takes a 79.9% stake in the company. Turns out to be \$182 billion authorized by the government in the end.
- **September 19:** The SEC restricts short selling in 799 financial companies for 10 days. The Treasury agrees to insure any publicly offered eligible money market fund.
- **September 21:** Goldman Sachs and Morgan Stanley on the verge of bankruptcy are permitted to convert to bank holding companies.
- **September 23:** \$3.2 trillion run on money market funds because of holdings of bad real estate paper. Fed guarantees funds.
- **September 25:** Bailout talks stall and cause an electronic run on some banks; Washington Mutual fails, the biggest bank failure in U.S. history. Most of WaMu's assets are sold to JPMorgan for \$1.9 billion.
- **September 29:** Citigroup agrees to acquire banking operations of Wachovia with FDIC sharing risks and receiving a stake in the company.
- **October 3:** Wells Fargo abruptly acquired Wachovia without government assistance. Pushing out Citigroup who couldn't close the deal without government aid.
- **Collapse of banks and economies world-wide**

# Panic in Financials 2007 – 2009:

## Inconsistency of Fed and Treasury Action Increases Market Panic

		<u>High Price</u>	<u>Low Price</u>	<u>% Drop</u>
WM	WASHINGTON MUTUAL INC	\$ 46.15	\$ 0.01	-100%
FRE	FEDERAL HOME LOAN MORTG G CORP	68.55	0.25	-100%
FNM	FANNIE MAE	70.57	0.30	-100%
AIG	AMERICAN INTERNATIONAL GROUP	72.97	0.33	-100%
CIT	CIT GROUP, INC.	61.46	0.23	-100%
C	CITIGROUP INC	56.28	0.97	-98%
WB	WACHOVIA CORP	58.80	1.25	-98%
HIG	HARTFORD FINANCIAL SERVICES	106.23	3.33	-97%
BAC	BANK OF AMERICA CORP	54.21	2.53	-95%
MS	MORGAN STANLEY	75.50	6.71	-91%
COF	CAPITAL ONE FINANCIAL CORP	83.84	7.80	-91%
PRU	PRUDENTIAL FINANCIAL INC	103.27	10.63	-90%

# Panic and Crash:

- **Administration and Treasury swing from a laissez-faire philosophy to actions that could best be termed socialistic.**
  - Paulson's bailout plan presented to congress was not well thought out and only a couple of pages in length.
  - Treasury does not follow plan.
- **Scare stories widely reported in the media, and the abandonment of the up-tick rule intensify the panic.**
  - Financial stocks were driven to such low prices that they had no ability to raise capital.
  - SEC chairman Cox refused to ban short selling despite being urged to do so by many financial experts.
- **Banks continue to drop sharply (KBE index falls nearly 90%).**
- **Collapse worsens under the newly formed Obama Administration.**
  - Market continues to freefall due to murky plans provided by Geithner.

# Financial Indexes: KBE and XLF

## November 30, 2005 – February 28, 2009

### Multi-Company Price

30-Nov-2005 to 27-Feb-2009 (Daily)

Price(KBE-US) Price(XLF)



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# The S&P 500

## September 30, 2007 – February 28, 2009

### S&P 500 (SP50)

28-Sep-2007 to 27-Feb-2009 (Daily)  
Local Currency

High: 1576.090  
Low: 734.520  
Last: 735.090



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# Global Panic and Crash:

Worst market drop in both relative and absolute terms since the 1930's:

Country	Index	Peak to Trough % Change
London	FTSE	-49%
United States	DJIA	-54%
Germany	DAX	-56%
South Korea	KOSPI	-57%
Spain	IBEX	-58%
France	CAC 40	-60%
Japan	Nikkei	-63%
Hong Kong	Hang Seng	-67%
Brazil	IBOV	-68%
Russia	MICEX	-75%
Shanghai	SHComp	-84%

# Looking to the Future:

The Negatives

The Positives

# Looking to the Future: The Negatives

- We are in the sharpest global recession since the 1930's.
- The unraveling of the U.S. and the Global economies was far more rapid than after 1929.
- This is the first time in modern history that a complete collapse of financial markets occurred, magnified enormously by the unavailability of credit.
- Errant policy making by the Treasury and the Fed, inadequate regulation, lack of risk control and almost exponential greed played a much larger role in this financial debacle than in 1929.

# Looking to the Future: The Negatives

- **Trillions of dollars poured into the U.S. banking system to loosen credit.**
  - However, most industries face a lack of credit.
- **Fear of deflationary forces drive prices lower.**
- **Widespread belief that the economy will be in the doldrums for years.**

# Looking to the Future:

## The Positives

- **Policy makers worldwide understand the potential deflationary threat and are taking action.**
- **Progress in returning liquidity to the banking system domestically and abroad continues on an unprecedented scale.**
- **Stress tests reveal that banks have successfully raised capital to appropriate levels.**
- **Confidence continues to rise.**
- **Rate of decline begins to stabilize in numerous economic indicators.**

# Looking to the Future:

## Forecasting Markets Ahead

# Looking to the Future: Forecasting Markets Ahead

- **The recession has bottomed but the improvement in stocks and real estate will be gradual.**
  - Not too early to say the worst is likely over.
- **From March of 2009 to today we had one of the sharpest rallies since 1933.**
- **Many stocks have doubled or tripled off their lows.**
  - Examples: GE, Bank of America, Citigroup.
- **Earnings begin to rise and should gradually move higher.**

# Looking to the Future: Forecasting Markets Ahead

- **With trillions of dollars poured into worldwide recovery we should see the highest inflation since the 1970's – 80's.**
  - Devastating for bond markets, Treasury's will perform poorly.
    - Keep your maturities short!
    - The worst investments of the last few years, Stocks and Real Estate, are likely to be the best performers.
  - Stocks typically fare well in inflationary or hyper-inflationary periods.

Questions?