

Financial Intelligence

2nd Quarter 2012

“Normal” Outcomes by John McCorvie, CFA

I do not believe that there is anything particularly abnormal in these elements...

Dr. Frankenstein: [to Igor] Now that brain that you gave me. Was it Hans Delbruck's?

Igor: [pause, then] No.

Dr. Frankenstein: Ah! Very good. Would you mind telling me whose brain I DID put in?

Igor: Then you won't be angry?

Dr. Frankenstein: I will NOT be angry.

Igor: Abby someone.

Dr. Frankenstein: [pause, then] Abby someone. Abby who?

Igor: Abby... Normal.

Dr. Frankenstein: [pause, then] Abby Normal?

Igor: I'm almost sure that was the name.

Dr. Frankenstein: [chuckles, then] Are you saying that I put an abnormal brain into a seven and a half foot long, fifty-four inch wide GORILLA?

[grabs Igor and starts throttling him]

Dr. Frankenstein: Is that what you're telling me?

From Mel Brooks' *Young Frankenstein*

I have frequently heard our economy described as abnormal over the last few years. And there are in fact many elements in our economy that have not occurred before in my lifetime: for example, the 10-year U.S. Treasury Note yield is at 1.61%, a qualified borrower can take out a 30-year fixed mortgage at 3.64% and the Case-Shiller U.S. National Home

Price Index (reflecting the market value of the largest single asset for most investors) has dropped 35% from its 2006 level. However, I do not believe that there is anything particularly abnormal in these elements, or in our mediocre economic growth or in our mediocre employment numbers. That does not mean I am not frustrated by these things, but I think it is reasonable to say our current economic environment is a normal outcome based on the actions (and inactions) that came before it. The United States (and the world at large) has an extensive history of booms and busts – though some are certainly bigger than others.

From a portfolio management perspective, our job is to strip away the emotion and media driven hyperbole (as best we can) and objectively evaluate current opportunities. The critical parameters that we consider, relative to each client's specific goals, are time horizon, liquidity needs and the risk vs. reward equation of each specific investment as well as of the portfolio overall. In the article below, Warren Buffett makes the case for evaluating the risk vs. reward component of an investment in terms of future purchasing power.

* * * * *

Why Stocks Beat Gold and Bonds by Warren Buffett

Unfortunately, we are unable to post Warren Buffett's article from *Fortune* online. Please call us at 1-800-298-9081 or send your address to us via email at peakam@peakam.com if you'd like a copy of the newsletter with the article

mailed to you. To access the shareholder letter from which the article was adapted please visit: <http://www.berkshirehathaway.com/letters/2011ltr.pdf>.

Company Profile: JP Morgan Chase by Noel Bennett and Tara Hume, CFA, FRM

Jamie Dimon always writes an excellent letter to shareholders in the annual report of his bank, JP Morgan Chase. It is educational, thorough and often opinionated, but as a battle-tested survivor of the great financial crisis of 2008, Dimon feels entitled to express his misgivings about the danger of the federal government overreacting to the crisis by imposing too much regulation on the banking industry.

In his letter earlier this year, he stated that in 2011 his bank's exposure to the troubles in Spain and Italy, and to a lesser extent Greece, was limited to approximately \$15 billion, primarily in loans to those countries. I took comfort in the fact that he went on to say, "in a bad outcome, we could lose \$3 billion, after tax," thanks partly to about \$6 billion of portfolio hedging accomplished through the use of derivatives.

Dimon obviously was convinced that the bank's Chief Investment Office in London knew what it was doing in its hedging operations. On April 6 of this year, however, he read a page-one article in the Wall Street Journal revealing that a trader in that office known as the "London Whale" because of the size of his trades was accumulating large, unexpected and unacceptable losses. The more Dimon found out about the trades the more concerned he became.

A military defense consultant named Jack London wrote recently, "You don't know what you don't know, and what you don't know can be a disaster." In the case of Jamie Dimon's oversight of JP Morgan Chase as CEO, he obviously didn't know enough. The result was at least \$2 billion of trading losses and possibly at least twice that much when the trades are finally unwound. It is important to note that the bank made close to \$19 billion in profits in 2011, and that the damage done this spring by the London Whale was largely to the reputation of the bank, and to Dimon's image as a white knight in the banking industry. Peak continues to maintain our half-position in JP Morgan Chase in the Model Portfolio*, but we

had not increased it to a full position in 2008-09 even though its shares became relative bargains. This was because we were leery of its huge derivatives business, which I believed we would never be able to fully understand. Fortunately, our partner, Tara Hume, has worked in the derivatives area of a large multinational bank, and after the London Whale fiasco came to light she wrote the following to a client in mid-May:

Here are my personal thoughts... I worked on the hedging side of the trading floor in Chicago for ABN AMRO for 2 years and it was our job to hedge the interest rate risk of the bank. At the most basic level, banks make money on interest rates – the spread between the amount they pay on deposits vs. the amount they receive on loans. But banks are much more complicated than this because they originate, buy and sell a lot of complicated assets. I specifically worked on hedging the mortgage-servicing portfolio, thus my whole job was to hedge only the servicing on mortgages that the banks owned. The first thing I learned is that there is no perfect hedge on any complex instrument. You have to hedge the interest rate risk, the convexity (curve of the underlying instrument), the duration (the slope of the line of the underlying instrument), the volatility, prepayment risk (in the case of servicing), etc. Every day I would look at the underlying mortgage servicing portfolio owned by the bank and do billions of dollars of notional hedging (generally using swaps) to try to control the risk of the servicing portfolio to the amount of risk we wanted to take. But swaps are linear derivatives, so you could not hedge the convexity (curve) of the underlying without the use of calls and puts, but still not a perfect hedge. It was always a trade-off on how much risk we were willing to sit with and where the risk was.

Second, if a bank could perfectly hedge something – an asset that is perfectly linear or that has an equal, but opposite offset – why would you want to? If you are perfectly hedged you cannot make money on the underlying

Company Profile: JP Morgan Chase by Noel Bennett and Tara Hume, CFA, FRM

instrument. Three seats down from me on my trading desk were the Mortgage Backed Securities (MBS) trading guys. It was their job to make money – to make trades that would earn the bank extra income. The interest rate risk group then hedged these trades, but not perfectly. The department head was in charge of determining the amount of risk that was acceptable to take so that money could still be made.

The derivative trades completed at JPMorgan Chase were created to hedge the bank's loan portfolio, which is primarily susceptible to interest rate risk and credit risk. Essentially, the Chief Investment Office (CIO) made three sets of trades. The first set looks like it was more or less a direct hedge on the bank's actual loan portfolio. These were credit default swaps (CDS) on high yield bonds – these CDSs make money as high-yield bond prices fall and should have served to help protect the bank against issues with its bond portfolio, after accounting for basis risk (which is the risk that the bonds do not perfectly offset). It looks like the second set of trades should not have been done because it was really a trade on the direction of the economy (read: interest rates) and not a hedge. In addition, this was an extremely large position in a relatively illiquid security. Then when that trade got going the wrong way it should have been unwound, but instead, they put another trade on to try to make up for that one. Each time a trade is added, basis risk is compounded.

Over the past couple of years, the CIO department had been making the bank a lot

of money and instead of getting increased scrutiny, it was getting more of a free pass. It sounds like Dimon agreed with the overall directional plays, but did not realize the risk (basis, liquidity, etc.) they were taking on by laying these swaps on top of one another – especially considering the size of the trades and the lack of liquidity in the specific instruments.

The goal of the bank is both to manage risk and to make money. The problem of course, is when people get greedy (as in the case of MBS securities in 2007-2008) and making money becomes more important than managing the bank's risk. There is no question that the incentives on these trading departments and risk managers are not promoting smart business practices. Does Dimon know this? Of course. But he may or may not have fully understood the extent to which these trades were being made in the absence of proper risk management. This needs to change. Splitting the bank from the investment bank might help the bank get back to real risk management practices and help protect the depositors as well as tax payers. Dimon took a big blow last week and there will likely be increased regulation because of it. I hope it is meaningful.

* * * * *

*The Model Portfolio is not a real cash portfolio. It represents the core direction of our portfolio management strategies. Individual client portfolios are managed in accordance with the clients' specific investment objectives and constraints. Historical results of specific securities are available upon request.