

MORGAN CREEK

CAPITAL MANAGEMENT, LLC

THE CHANGING INVESTMENT RISKS, OPPORTUNITIES AND LESSONS DUE TO UNCLE \$AM

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One of the greatest documents in the history of mankind is the United States Declaration of Independence, the second paragraph of which reads: "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness -- That to secure these rights, Governments are instituted among Men -- deriving their just powers from the consent of the governed. That whenever any Form of Government becomes destructive of these ends, it is the Right of the People to alter or to abolish it, and to institute new Government, laying its foundation on such principles and organizing its powers in such form, as to them shall seem most likely to effect their Safety and Happiness."

This served as the inspiration for the United States Constitution and its Bill of Rights which are the foundation of our country and its laws, defines the three separate branches of government, and establishes our system of checks and balances. Despite the relatively short history of the United States relative to many other countries on the planet, it is the oldest documented constitution still in use by any nation in the world today. The progress and growth of the U.S. during this short time frame from the frontier wilderness it was at the time, to today's global superpower, is nothing short of remarkable, almost miraculous. That early engines of this growth included egregious trampling of rights violating said documents is deeply regrettable. Fortunately, these governing documents included the very laws and tools to address those violations. Ours is indeed the worst system of governance excepting all others. There is no infallible, perfect system of governance. So is the case with investing.

My personal hero, Thomas Jefferson, recognized this fact of governance as well as the inherent threats to our own system. He never believed in complacency and stated at the time that "I hold that a little rebellion now and then is a good thing, and as necessary in the political world as storms in the physical ... It is a medicine necessary for the sound health of government." Again, so too apparently is the case in investing.

We've recently witnessed the greatest investment bubble in our lives, as well as its implosion which continues to reverberate today. The bigger the bubble, the greater the inherent and potential risks -but also the greater the inherent and potential opportunities. Great bubbles always sow the seeds of volatility and misvaluations created by force (Mass times Velocity),

greed/fear/panic, and the inevitable disruptions of pockets of liquidity. These can often also create shocking distortions to correlations among otherwise diversified and disparate asset classes. In other words, a very unsettling environment that will severely test the skills of every investor.

One major factor - and risk - in investing today is not new but is much more significant than ever: government intervention. Obviously, government has grown in myriad and astonishing ways over time. So too has its bureaucratic nature. But most disturbing is its increasing openness to outside special interests. Despite regular attempts to address this problem, the best that can be hoped for seems to be a decrease in the rate of governmental growth. Government's growth and clout in the area of finance has never been greater on an absolute basis. It's no longer a joke that Washington, D.C. has displaced New York as the center of finance (well, assuming one distinguishes Goldman Sachs from the U.S. government that is. Just joking. A little). There is a good reason that Washington, D.C. has experienced a robust real estate market while virtually all other cities have not.

For the purposes of this discussion, assume Government individually and collectively holds complete sincerity and dedication to missions. It would be one thing if Government held any particularly strong expertise, intelligence, wisdom, moral bearing and objectivity in their positions of power. If anyone actually believes this, I'd like to sell them a beautiful bridge crossing the East River, cheap! Don't look at Social Security, Medicare, Medicaid, the Prescription Benefit, Education, Energy Policy, Iraq or Afghanistan, etc, ad nauseum, as examples. It's different this time. Right...

If government was so smart, wise and not beholden to special interests, why has it been asleep at the switch for so long? The credit bubble was many years in the making, and reached unprecedented levels. As with the Savings & Loan crisis in the late 1980s, Long Term Capital Management, Enron, etc., there were numerous, clear, cogent and prescient warnings to Government from respected experts, all to no avail. While the banking and insurance industry are two of the most heavily regulated industries in the U.S., these regulations were insufficient. But even if they had been sufficient, why did government allow an unregulated shadow banking and insurance industry to grow right under its nose, and to the extent where it became much larger than the standard regulated banking and insurance industries? Some say Alan Greenspan facilitated if not created the bubble via his policy of decreasing interest rates beyond reason. Some say industry influence is too great, via industry veterans with vested interests in their

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prior companies and industries, who became embedded in the power structures of the Treasury Department, Federal Reserve, and Government, generally. Others say that political influence in the form of campaign finance and PAC money is a major factor (with both political parties being guilty). Interestingly, research firm Strategas publishes what it calls its "K Street Index" of the top 50 companies in the U.S. that spend the most on lobbying (as a percent of assets). This index consistently and materially outperforms the overall market.

As a measure of the growth of economic power that the average individual U.S. government representative holds, look at how the following three dimensions of economic clout have grown over time: 1) the number of citizens that the average bureaucrat represents, 2) the average U.S. GDP per capita, and importantly, 3) the average U.S. Budget Deficit per capita. Adjusting for inflation, today's representative holds thousands of times more economic influence than his predecessors, fueling much greater potential distortions in motivations, incentives and actions. No wonder political candidates will say anything, do anything and spend anything in order to get elected -especially since the overwhelming majority of incumbents get re-elected. In the hands of mere mortal humans, such power and authority can not help but be misdirected at times. Whether by special interest funding, or merely by popular if uninformed or knee jerk response, incumbents are constantly tempted to do the expedient rather than the wise things. Adding gasoline to the fire, the Supreme Court recently ruled that corporations were effectively the equivalent of individual citizens and accorded the same rights and privileges. These are merely facts of political life today (together with the fact that Thomas Jefferson and his peers are spinning in their graves).

Consider the ability to tax. The founding fathers would have been mortified to see the scope, magnitude and complexity of the tax code as it exists today (recall the Boston Tea Party). One merely has to look at the progression of the income tax through U.S. history to see malignant growth (there was no income tax until 1861 when it was first instituted - at a 3% rate - to help fund the Civil War). More ominously though is the fact that the tax code has become a significant way that special interests can carve out favorable terms for themselves. Regardless, the ability to tax is the ability to strongly incentivize behavior and capital in myriad ways, including ways in which government has never before thought, even to the detriment of the original aims of said tax.

Consider regulations. This is another major functional (often dysfunctional) governmental arena with similar forces to

direct behavior, capital and competitiveness. The granddaddy of the current administration's regulatory focus is of course Healthcare, a major theme of Morgan Creek's. This is currently playing out right under our noses. As a major sector of our economy, it bears watching very closely.

One of the big initiatives that government wishes to incentivize is the ability to secure independent and clean energy. After thirty-five years, two Arab oil embargoes, two Iraq wars, and the worst attack ever on American soil, U.S. dependence on energy - from distinctly unfriendly suppliers at that - has reached record heights. The ramifications for U.S. energy dependence, national security, international relations, the environment, and the economy are manifest. Government finally seems to get this. Energy is a major theme at Morgan Creek, and how government tries to properly incentivize here will be a critical factor in how our private and public energy managers ultimately perform.

Consider government statistics, e.g., CPI and unemployment. Government is the keeper of the statistics, and one would have to have been born yesterday in a cabbage patch to believe that the stats aren't sometimes gamed, manipulated or obfuscated. In times of inflation, there is every incentive to understate inflation because of the massive liabilities that government holds in the form of COLA adjustments to their (technically bankrupt) entitlement programs, not to mention record amount of Treasury debt. Same thing with unemployment stats, where there is every reason to underestimate these figures. The point here though is that there is an increasing short-termism in financial markets today compared with history, and any release of info or data is usually pounced upon immediately by sizeable players without the inclination, patience, temperament or even desire to digest reality from fantasy. So many market participants shoot first and ask questions later. Markets can move abruptly and significantly in response.

Consider the power to outright bully. The fact that the government took over GM and then trampled over the bondholders, in clear disregard of well established bankruptcy law, is chilling. Even more so if one reads political payback to certain blocks of voters into that equation. Another example is the dictation of banking compensation. While some of this is understandable given the outrageous conduct and payments of some major players in the industry, and public opinion justifiably rings loud and clear, there can not be simplistic measures if we truly want the banks to work themselves out of their challenging troubles.

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This might all seem as unduly harsh criticism of U.S. government. Though the jury won't be out for at least several years, Bernanke, Geitner, et al, seem to have avoided a Great Depression scenario thus far. If there was a massive hangover of too much debt and leverage in the system, the record-smashing government stimulus was intended as a short term hair-of-the-dog palliative for said hangover. It would seem to beg common sense and intuition that the answer for too much debt is more debt, but at least the drunkard was kept alive instead of becoming comatose or pronounced DOA.

The financial crisis in 2008 is an interesting case study of government intervention. The crisis was exceptional and would severely test any person(s) or entity. As the great credit bubble was nearing its apex in the first days of 2008, the Fed instituted a massive, surprise 75 basis point cut in the Fed Funds rate - the first time in our country's history it has ever done so. As the year unfolded, major governmental intervention took place in unprecedented ways with the Bear Stearns bailout, the Fannie and Freddie bailouts and then in rapid succession over a few days in September, the incredible collapse of Lehman, the bailout of AIG, and the encore, the ban on short sales of financial companies, the epicenter of the credit crisis (but defined in a ridiculously broad way). The Treasury then signaled it would embark on a program of purchasing certain asset-backed securities from banks in an effort to ease their crisis ...and then abruptly announced in November that they would not do so. All of these interventions made it extraordinarily difficult and challenging for the average investor to navigate - especially, ironically, the investor that saw and predicted the credit bubble and its bursting. Each one of these surprising and sometimes inconsistent, illogical, hypocritical, morally hazardous and even self serving interventions hurt investors with the "correct" short credit positioning - and sometimes even those with long credit positions as well. Keynes's famous adage that "The market can remain irrational for longer than you can remain solvent." is a truism nobody can deny. Bubbles can last far longer and farther in magnitude than you'd ever think possible. Throw government intervention into the mix and the lessons learned are to expect the double unexpected! More lessons later on this.

Other governmental programs like TARP, TALE, PPIP, etc. were intriguing public-private initiatives to make progress in innovative ways. These led to various opportunities in mortgages and other asset-backed securities for the astute and nimble investor. It is surprising how rapidly some of these opportunities closed as various market participants responded quickly, and in size. It is crucial to stay abreast of

these programs and to identify managers with an expertise in the area who should be able to quickly navigate and exploit the programs and changing environments.

Government has a huge interest in defending the home and mortgage market because that is ground zero for middle class America (and beyond). And after all, government had previously deliberately embarked on an official goal of enabling as many citizens as possible (vs. as feasible) to become homeowners - to great "success." So in an effort to combat the subsequent housing crisis, it instituted various programs, most notably, a massive buying spree of agency mortgages to keep liquidity high and mortgage rates low. Together with keeping general interest rates low, this would help keep mortgage rates low for home buyers, and help those with adjustable rate mortgages who couldn't even afford their prior rates. Other programs would help encourage, well, more debt in the case of the first time home buyer's tax credit. Now, why extend it to just first time home buyers, and why is \$8,000 the right amount? Trust them -they're from the government and here to help. Other programs such as the mortgage modification program have been essentially impotent. The latest announcement has been that the government will "put" back FNMA and FHLMC securities to the banks from which they bought them if there are any material impairments to the securities. The effect has been a sharp sea change in estimated prepayment speeds -the most important factor in mortgage valuations in this environment, and hence a sharp change in the prices of mortgages and especially mortgage derivatives such as I/Os, P/Os and their inverse derivatives. Having expert managers here not only protects you from carnage but can help you capitalize on the abruptly changing environment as well.

Government of late is also proposing a change to the uptick rule regarding short selling. As a refresher, the SEC had instituted the uptick rule in 1938 as a response to the Great Depression. It rescinded this rule in July 2007 (right into the teeth of the great bear market). The SEC is now proposing a modified uptick rule that would kick in once a stock declines ten percent. This is not only a reasonable change, but it is a change that should not challenge a good long/short manager in the least. After all, most long-short managers had conducted business under the old rule. Kudos to the SEC for not overreacting to the bear market -or to the general public's - (and many government officials') less-than-informed, knee jerk reactions.

One governmental proposal that might well have very serious negative repercussions is a transaction or "toll" tax for securities. Depending on the amount of such a tax, how

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it would be imposed on what kinds of securities and activities, and how it would be implemented, all have potentially major repercussions on certain strategies and managers. Likewise, initiatives from governments around the world (to not pick on only the U.S.), are considering varying degrees of regulating Credit Default Swaps and other derivatives. Again, it's very important to follow and understand this particular sausage making.

The upshot of all this is that big Government is a very major player in markets these days, and whether you deem it friend or foe, it behooves you to keep close. To this end, Morgan Creek is retaining a research firm with a strong and informed Washington, D.C. presence and command.

Other lessons we have learned: there is usually a bullet out there you can't or don't see that has your name on it. Even when you are right, you can be wrong. Use the dimension of time as a risk diversifier. Have several different hedges to express the inherent risks you see, despite the basis risk some may themselves hold. Hedge even for risks you don't see, or see as low probability events; just size these various hedges appropriately. Importantly, increase the liquidity of your portfolio where it makes sense. Such liquidity gives Morgan Creek, the manager of managers, much more nimbleness to make tactical changes, something we've historically added value by doing. Buying/selling/trimming managers is not always sufficiently facile in this regard. We continue to research an amazing array of managers in various strategies with much better liquidity, but which liquidity is still wholly appropriate for their styles. Furthermore, these managers are adding a different approach and return stream to our heretofore "fundamentalist" heavy array. Rounding out this liquidity further is an ever burgeoning - and we expect ever improving -scope of ETFs, Closed End Funds, hybrid mutual funds, long-only managers (where appropriate), and even replication strategies.

We've never been more excited about the measures we've taken in response to the lessons learned, the changes and additions to our funds, and the investing landscape which is right in our -and our managers' -wheelhouses.

If you have ideas or topic suggestions for Mr. Hennessy's next upcoming article or would like to send us questions, comments or feedback on this piece, please contact Andrea Szigethy at aszigethy@morgancreekcap.com. We look forward to hearing from you.