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COVER STORY

Not So Smart

In an era of easy money, the pros forgot that the party can't last forever

COVER STORY PODCAST -

The boasting and bluster that marked the just-ended era of easy money varied depending on the speaker and his stake in the boom. But the underlying message was consistent: This time it's different. When it came to the hazards associated with borrowing, the old rules no longer applied.

The titans of home loans announced they had perfected software that could spit out interest rates and fee structures for even the least reliable of borrowers. The algorithms, they claimed, couldn't fail. With similar bravado, buyout firms bid up private equity deals, arguing that investors had an insatiable appetite for the increasingly risky and mammoth loans used to fund them. "I don't think it's a bubble," David M. Rubenstein of Carlyle Group told the *Financial Times* in an interview last December. "I think really what's happening now is that people are beginning to use a different investment technique, and this investment technique, private equity, adds real value."

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Hedge funds were all too happy to enable the leverage arms race. They, too, borrowed to the max so they could gorge on the debt that financed the housing and buyout booms. "The consumer has to be an idiot to take on those loans," John Devaney, chief executive of United Capital Asset Management, said in May, referring to dicey adjustable-rate mortgages. But since there were plenty of "idiots" out there, and legions of lenders eager to serve them, Devaney and other hedge fund managers eagerly devoured the securities confected by investment banks from batches of dubious home loans. This securitization, the argument went, would spread the risk far beyond banks and mortgage companies. In March, Devaney bragged that mortgage-backed securities were one of his "best-performing investments."

It didn't work out that way. In June, Devaney's Horizon funds booked a loss of more than 30%, according to *Hedge Fund Alert*. Shortly after, United Capital suspended redemption requests by investors trying to pull out. Devaney did not return calls for comment. These troubles came amid similar havoc at other hedge funds and bankruptcy filings by scores of mortgage lenders. On Aug. 22, Lehman Brothers Inc. (**LEH**)shuttered its subprime mortgage group. Dozens of high-profile buyouts have stalled as the credit market has seized up. And during the past month, the value of U.S. stocks has plummeted by more than $2.2 trillion, or 10.5%, according to TrimTabs Investment Research.

Making sense of this mess is daunting. One good place to start: the ways various financial players indulged in layer upon layer of leverage, much of it far from transparent. Mortgage lenders threw out common sense underwriting standards. Wall Street sliced and diced the loans, creating the illusion that risk somehow disappeared in the process. Hedge funds then multiplied the leverage by borrowing copiously to buy securities based on the rearranged mortgages. In their version of the game, private equity firms used loads of debt to launch unprecedented buyouts.

What some of the smartest guys in each of these fields seemed to forget is that new paradigms can crumble suddenly. Many miscalculated how long the period of easy credit would persist.

Some are now backpedaling. Home lenders are tightening standards, once again demanding that buyers be able to afford downpayments. Banks are cutting credit to some hedge funds, forcing managers to sell some of their stocks, bonds, and other securities. But some financial players who vastly underestimated the implications of the leverage they employed aren't exiting entirely. Moreover, we don't yet know the full extent of the complex borrowing arrangements on which the recent boom was built. "There's embedded leverage all over the place, and no one knows how far it goes in the system," says Michael Greenberger, a former director at the Commodity Futures Trading Commission who teaches law at the University of Marlyand. "There's billions and billions of dollars racing around the economy that no one can track."

Bruce Wasserstein, a veteran architect of mergers and acquisitions who heads the investment bank Lazard (**LAZ**), warns: "Financial institutions spread the risk to people who weren't quite sure what they were getting. Others thought they had outsmarted the market and added leverage to make it interesting." He expects "lots more embarrassment in unforeseen places, where some people tried to spike their returns with this paper without regard to risk".

MORTGAGE FINANCE: `A SECRET SAUCE'

Mortgage lenders in recent years claimed they had perfected the science of underwriting. Armed with huge consumer databases, they mined thousands of variables, such as late payments, credit scores, and bankruptcies. Some, like Countrywide Financial Corp. (**CFC**), the nation's largest home lender, developed proprietary systems. Others relied on software they purchased and tweaked. "It's like having a secret sauce; everyone had their own best formulas," says Edward N. Jones, CEO of Austin (Tex.)-based ARC Systems, which sold technology to HSBC, (**HBC**) First Franklin (now owned by Merrill Lynch & Co. (**MER**)) and many of their rivals.

It was the assumptions and guidelines that lenders used in deploying the technology that frequently led to trouble, notes industry veteran Jones. "It's garbage in, garbage out," he says. Mortgage companies argued their algorithms provided near-perfect precision. "We have a wealth of information we didn't have before," Joe Anderson, then a senior Countrywide executive, said in a 2005 interview with *BusinessWeek*. "We understand the data and can price that risk."

But in fact, says Jones, "there wasn't enough historical performance" related to exotic adjustable-rate loans to allow for reasonable predictions. Lenders "are seeing the results of not having that info now." In many cases, lenders and brokers dropped any pretense of seriously applying underwriting standards as they doled out loans without proof of borrowers' income or assets. First Franklin says it resisted making a lot of the unwise loans that its rivals did. Countrywide, which on Aug. 22 got a $2 billion equity investment from Bank of America (**BAC**), and HSBC declined to comment.

The Street meanwhile helped power the home-lending binge by bundling the loans into securities sold to big investors. Innovations like collateralized debt obligations (CDOs) provided lenders with another potent option for selling off mortgages. These complicated investment pools filled up with mortgage-backed securities. CDO managers claimed they could diffuse the danger by spreading the risk to a broader array of investors.

So the mortgage business swiftly expanded to record volume of more than $3 trillion in 2005, but all the Wall Street money only made lenders more reckless. The fallout has been painful: Droves of buyers who couldn't afford their loans going into foreclosure, home prices falling nationwide, and fears of recession if consumer spending dries up. Still reeling, the mortgage industry has swung back toward convention. Downpayments are in; adjustable-rate loans, out. But with $750 billion of adjustable mortgages due to reset through June, 2008, most likely at higher rates, more defaults and foreclosures are coming.

PRIVATE EQUITY: `A GOLDEN AGE'

As recently as April, buyout legend Henry Kravis proclaimed a "golden age" of private equity. Perhaps he should have called it a golden age of CLOs—collataralized loan obligations.

Like mortgage lenders, the giants of private equity have relied on complicated investment pools to fund their binge. CLOs are cousins of collateralized debt obligations. Managers of the investment pools buy groups of risky, junk-rated loans from banks that have financed buyouts by Kravis and his competitors. The CLOs package the loans, then divide them into risk levels. While the individual loans carry low credit ratings, three-fourths of the securities marketed by CLOs magically boast AAA marks. (That's because some investors give up extra yield in exchange for better protection against losses.)

The financial alchemy has allowed private equity firms to attract a whole new base of investors, including pension funds and insurance companies that never would have bought those risky loans outright. U.S. CLOs raised $100 billion in 2006, quadruple the amount two years earlier.

Buyout firms have generally fronted 30% of the equity in recent deals, vs. just 15% two decades ago. But that doesn't mean firms have been more cautious. Steeled by the seemingly insatiable demand for CLOs, they became bolder and bolder in the deals they pursued. After Kohlberg Kravis Roberts & Co. and Texas Pacific Group's $44 billion bid for Texas energy giant TXU in February, analysts began putting odds on imagined future megabillion-dollar targets like Home Depot Inc. (**HD**)

As private equity firms bid up the prices for ever-larger LBOs, the transactions began getting riskier. A key measure of leverage, a company's total debt divided by operating earnings, skyrocketed from 4.7 in 2004 to 7.0 in the second quarter of 2007, according to Standard & Poor's (**MHP**) LCD. Meanwhile, the ability of companies to cover the interest payments of that debt dropped sharply; the ratio of profits to interest fell from 3.4 to 1.8 in that period.

At the same time, loan terms got looser. For example, in the buyouts of Freescale Semiconductor and retailer Claire's Stores (**CLE**), LBO firms peddled bonds that allowed the companies to postpone interest payments until the bonds matured—a previously unheard of feature. Such stipulations applied to 10% of all junk bonds sold in 2007, vs. virtually none 18 months earlier, according to Lehman.

The red-hot demand for even the junkiest of loans allowed many firms to delude themselves into thinking they could endlessly pursue deals. In the three months through July 31, firms announced $254 billion in buyouts, as much as in 2004 and 2005 combined, according to Thomson Financial (**TOC**). One credit crunch later, the market for LBO financing has evaporated. Investors won't buy the loans at current prices, leaving banks on the hook for $300 billion in loans to buyout artists.

So far, no big deals have collapsed. The hope is that the credit environment will improve in the fall, and stalled deals will move through the LBO pipeline. But there may be more pain ahead.

HEDGE FUNDS: STEALTH DEBT

Hedge funds helped power the mortgage and buyout booms by hungrily consuming securitized subprime debt and loans used to fund buyouts. By borrowing much of the money they invest, in some transactions up to 90%, hedge funds add another potentially dangerous layer of indebtedness to already highly leveraged markets. Because hedge fund disclosure is limited, huge pockets of leverage are barely visible. This stealth debt helped cause the problems in the subprime market to spread far beyond the housing sector.

One example: the hundreds of billions of dollars in so-called repurchase lines of credit, or repo loans, that Wall Street banks have lent to hedge funds. Disclosure of these esoteric agreements is murky at best, so their precise value can't be quantified. Another tool that pumps up leverage by untold billions is the total return swap. These arrangements allow a hedge fund to capture the gains of a security without having to buy it outright and with only limited collateral.

For some funds, extreme leverage became an acute problem when the mortgage crunch caused banks to doubt the value of the subprime bonds and CDOs the funds held. Banks pulled their lines of credit, forcing funds to come up with the full value of those assets. That caused dire consequences because, in some instances, the funds paid as little as 10 cents on the dollar and now had to come up with the remaining 90 cents. Many funds, including ones from Goldman, Sachs & Co. (GS) and Renaissance Technologies, were forced to sell better-performing bonds, stocks, and commodities to pay back nervous bankers.

Falling stock and commodity prices hurt others that weren't even exposed to the housing market. Ordinary investors saw their portfolios shrink suddenly as the Dow Jones industrial average lost 1,000 points only a month after hitting 14,000 for the first time in July.

For now, the unwinding and selling has slowed. Most hedge funds suffered double-digit losses during the first part of August, although some are already back buying CDOs and CLOs at sharp discounts and with large amounts of leverage. How much? No one really knows.

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