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Financial Market Cycles: When Virtuous Circles Become Vicious

The capital markets, the economy, and Wall Street firms all experience cycles. For capital markets, the cycles consist of bull and bear markets; for the economy, boom and bust. For Wall Street firms, the cycles are of financial innovation, risk-taking, limit-pushing, and hefty compensation, followed by retrenchment, revulsion, write-offs, and layoffs.

An upward cycle becomes a virtuous circle when a favorable trend results in behavior that is self-reinforcing – which then exacerbates the trend. The housing market is one of many such examples. Rising house prices, until recently, made home lending appear very low risk, attracting fresh capital sources; easier credit standards – and, broadly speaking, credit standards have become nothing but easier for half a century – caused loans to be extended even to people with poor credit histories. Greater credit availability, discounted financing, and Wall Street’s securitization engine allowed borrowers to bid up home prices in a truly virtuous circle. Poor stock market performance from 2000-2002 undoubtedly induced many individuals to begin to speculate profitably on homes instead of unprofitably on equities. So long as house prices continued to rise, loan losses would be low, reaffirming the “creditworthiness” of risky borrowers.

But eventually cycles do end, and circles stop being self-reinforcing; what is seen as virtuous on the way up is often experienced as vicious on the way down. During 2007, credit conditions tightened greatly for all U.S. residential lending, holders of securitized mortgage debt and CDOs were forced to take huge write-offs, and a dramatic slowdown in new home sales caused extreme pain for homebuilders. The masses, who as recently as 2006 could not imagine home prices not rising, now cannot imagine them not falling further.

Virtuous circles have formed in many areas of the financial markets, driven, in part, by a strong economy, a benevolent Fed, and investor ebullience. Consumer, corporate, and commercial real estate lending have burgeoned in ways similar to residential lending. We believe there have been remarkable excesses in each of these areas, exacerbated by the moral untethering enabled by securitization, the greed of lenders chasing returns, and the painfully short memories of everyone concerned. Succinctly, we don’t expect the subprime mortgage debacle and housing contraction to be isolated events but more likely the first failure in a broader reckoning. The overstretched consumer seems unlikely to be a more reliable debtor when it comes to servicing a car or credit card loan than they proved to be as mortgagees. The equity of highly leveraged companies, in many cases purchased by private equity firms at fantastic valuations that could not be justified today,

has increasingly become an out-of-the-money call option on the hope that things somehow work out.

The 2000's bull market in commercial property was driven by a precipitous drop in capitalization rates (the required yield demanded by investors). By 2007, this left many properties carrying more debt than these same properties were worth only a few years prior. Commercial mortgages and securitizations will certainly experience their share of difficulties now that financing spreads have widened, property prices have stalled out, and vacancies in certain asset classes are starting to rise.

The stock market is another area where favorable tailwinds have turned into headwinds. Rather incredibly, the credit crunch, which clearly has an impact on the cost of corporate financing, the general availability of credit, and the value of companies to a leveraged buyer, did not prevent most of the broad stock market indices from rising in 2007. Neither did the skyrocketing price of a barrel of oil, which jumped almost 60% during the year. While no one can forecast the stock market, and while the weak dollar does make U.S. shares look inexpensive to foreign buyers, we would not be surprised if the incipient economic slowdown and continued credit deterioration contribute to stock market weakness as 2008 unfolds.

One of the ongoing complexities of security analysis is that you can never satisfactorily determine where you are in a cycle. How long might a bull or bear market last? Had you avoided the upward frenzy of 1929 and missed the great crash only to jump into the market in early 1930, the pain you would have felt by 1933 would hardly have been different from the agony of those who had invested at the 1929 peak. We will not be certain until much later whether the so-called bargains of January 2008 were truly undervalued or merely dangerous temptations to value-starved investors.

Other reckonings are under way as well. Managers of money market funds are clearly re-examining the wisdom of incurring any credit risk whatsoever, since the brunt of investment losses often ends up being borne by their management companies rather than their funds. Investors in money market and bond funds are certainly scrutinizing their holdings with a newfound seriousness. The world has turned nearly upside down for state and local treasurers, who, with the solvency of all the incumbent municipal bond insurers now suspect, are actually able to issue uninsured debt at interest rates no higher than insured debt. These same treasurers are getting an on-the-job primer in the management of pooled debt vehicles and retirement funds, beginning with a tutorial on the dangers of trusting the ratings of any debt instrument.

No one can know what the future holds, but a further revulsion against risk in all its forms would not surprise us. Higher borrowing costs, tighter lending standards, and more cautious investor behavior could further slow economic activity, with a resultant fall in securities prices. This is a scenario that we do not consider remote, one that we fear, and one that we, no matter how well positioned, will need all of our experience, resourcefulness, caution, and acumen to survive reasonably intact.