HAWK100

HAWK Talon

Monthly News from Hawk100 Issue 13, January 2010

Hope in Change.

Obama swept into the presidency with the cause célèbre, "hope and change." With hubris, Obama confidently claimed during his campaign in February 2008, "We are the ones we've been waiting for. We are the change that we seek."

Maybe in 2008, but this is 2010 and things have certainly changed in two years. Obama spent a year in the Oval Office attempting to impose change upon a skeptical electorate. A domestic agenda to expand government influence through entitlements and regulations, and a foreign policy reaching out to regimes of ill repute has Americans questioning the vector length and direction of change.

Scott Brown's January election as U.S. Senator for Massachusetts — filling the vacant seat of the late Edward Kennedy — changed the Senate and thus the vector length and direction of change. With that, a different sort of hope arrived.

The 41st Senator of the minority party provides America an opportunity to bring changes that lead to a brighter future. For example, where Obama's agenda carried the right direction only too far, number 41 could shorten the legislative reach to frame a more reasonable outcome.

Congress should take note of a Brown campaign slogan, "the peoples' seat."

Your wealth.
Your life.
Aligned.

6600 Perimeter Dr.
Suite 200
Dublin, Ohio 43016

614.791.HAWK

www.hawk100.com

Derivatives Explained.

Nick Clemens, Proprietor of Dayton drinking establishment circa 1860.

Hawk100 takes investing seriously, especially when it concerns the wealth of Hawk100 members, but occasionally introduces humor to bring brevity to what can be a cold world in finance. Hawk100 often relies on derivatives instruments to execute investment strategies but sometimes struggles to explain their function in a portfolio.

Simply said, Hawk100 uses derivatives to align investment risk with your specific objectives. Typically, Hawk100 seeks derivatives that reduce portfolio risk but, on rare occasions when suitable and authorized, has used derivatives to lever portfolio risk when conditions are extremely favorable. That's the textbook explanation, but I want to paraphrase a sobering but humorous email I received from a colleague who manages a multibillion dollar institutional portfolio.

The email tells of a drinking establishment proprietor in a depressed industrial city. Unemployed customers cannot afford to patronize the bar, so the proprietor derives a marketing plan that allows customers to drink now, pay later, essentially extending credit to customers on a deferred payment plan. The proprietor sees booming business volume, wields goodwill from the credit plan, and regularly raises prices with little resistance leading to explosive revenues.

Witnessing the brewing results, a bank lends more money to the establishment with the customer receivables pledged as collateral. Their investment banker securitizes the loan. In other words, it bundles the loan with many other loans and stratifies the loan into different risk categories, called tranches. "Early" tranches receive the first principal payments but earn low yields, and "late" tranches must wait for others to be repaid first but earn higher yields.

The securities are sold to investors who naively purchase the loans at low yields believing that they are safe because a AAA-rated company securitized the loans. The bonds rapidly rise, and become hot issues for brokerages. To maximize profits, brokerages write huge contracts designed to rise rapidly in value when the bond prices rise. Some investors recognize their naiveté regarding the underlying creditworthiness and purchase insurance in case of default, but the insurer understates default risk with easy economics. It invests assets held to cover defaults in a portfolio of bonds and other contracts designed with similar terms as the ones it insures.

A risk manager at the lending bank demands payment from the bar. The bar owner demands payment from customers, but being unemployed alcoholics they cannot pay their debts. The bar defaults on the loan. Overnight, the securitized bonds drop in price by 90%. Collapsed bond values destroy bank liquidity and render the derivative contracts worthless. The insurer fails to cover the default since it held no assets in reserve. Absorbing huge losses prevents the bank from issuing new loans, thus freezing credit and community investment.

Since many of the bond investors were individuals and businesses in the depressed industrial city, they suffer the most brutal losses and are unable to recover. With the bank's tighter credit, businesses close; jobs are lost; and houses foreclosed. Fortunately for banks, brokerages, and their executives, the government intervenes with subsidies to keep them alive. But, the government imposes strict regulation on the bailed out industry and levies taxes on employed folks to pay for the subsidies. With such strictures, the economy struggles and suffers a prolonged recession.

Lessons herein were covered in a recent Hawk100 presentation how to avoid common investor mistakes. Have a strategy; don't buy high or sell low; and understand risk and companies underlying investments. Work with Hawk100.

By Richard Clemens, CFA, President