



DID THE GOVERNMENT REALLY CAUSE THE 2008 CRASH?

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Remember that “financial crisis” in 2008? Certainly you do if you live on planet earth. While it seems like a long time ago, the time has come to tell the real story of how our bumbling government officials contributed to the 2008 crash. This story starts at AIG and then moves onto Structured Investment Vehicles (SIVs) and finally finds itself in leveraged bond products, like the Falcon Funds. It may not be widely known that AIG dominated the Credit Default Swap (CDS) market that allowed SIVs and leveraged bond products to exist. When the CDS market collapsed, it triggered a “Black Swan” event where leveraged debt also collapsed spectacularly. This resulted in an estimated \$1 trillion of corporate and municipal debt being “dumped” in 2008.

Most investors witnessed the stock market crash in 2008, and have been led to believe that’s where the fire started. But the truth of the matter is that the bond market crashed first, which in turn triggered heavy selling in the stock market. This was simply because the stock market was more liquid than the corporate and municipal bond markets. So essentially, 2008 is really a story about leveraged debt being unwound and forcing equity selling as the CDS market collapsed.

Credit Default Swaps

For those who are not familiar with a Credit Default Swap (CDS), here’s a quick rundown. The Big Short covers the subject really well, if you have a chance to watch it. If you haven’t had the chance, I’ll describe CDSs briefly here. A Credit Default Swap is technically defined as *a financial contract whereby a buyer of corporate or sovereign debt in the form of bonds attempts to eliminate possible loss arising from default by the issuer of the bonds. This is achieved by the issuer of the bonds insuring the buyer’s potential losses as part of the agreement.* The easiest way to think of it is Bond Insurance. It is an insurance policy written to protect against the default of a bond.

If you hold a million-dollar corporate bond you can buy a CDS (or swap the credit default risk) with the seller of the CDS. The seller insures the bond in the event of default. The seller earns a premium payment annually just like any other insurance policy. The buyer pays the premium, but is protected if the bond fails. At least this is true in principle. In reality, the CDS is a very effective, risk-limited way to short a bond. The other inherent beauty or danger is that CDSs can be written many times over on the same bond. If one bond goes bad and defaults, it can actually have the effect of defaulting many times over! Enter the wild word of leverage...

AIG

When it came to writing insurance on bonds in the form of Credit Default Swaps, AIG dominated. It makes sense; they are in the business of collecting premiums. The former New York Attorney General, Eliot Spitzer, went after Hank Greenberg, who was the Chairman of AIG, effectively making Greenberg the poster boy and figurehead for all that was wrong with the flawed CDS market of 2008. While AIG dominated the CDS market, many other companies participated, even Warren Buffett's insurance company. Hank Greenberg is truly a brilliant man and in my opinion, was unfairly demonized by Eliot Spitzer. Ironically enough, Hank Greenberg eventually prevailed in a key court ruling against Spitzer who charged that he acted inappropriately. It will be interesting to see if the government will ever reimburse Hank Greenberg and shareholders for all the damage that Spitzer did.

Essentially, Hank Greenberg was kicked out of his own firm and AIG went through two CEOs very quickly thereafter. The government then appointed an auto insurance executive, Edward Liddy, to run AIG. Shockingly, Edward Liddy did not fully understand the CDS market, but liked all the income it was generating through premiums, so under his leadership AIG became extra competitive and sold more CDSs and even lowered rates. The much-desired side effect was that he and selected AIG executives could get big bonuses on all their new CDS business. Imagine insurance becoming so competitive that rates were pennies on the dollar. This is taking dollar risk for penny premiums. Alarmed that AIG was underwriting CDSs at uncompetitive rates, Warren Buffett and other CDS underwriters fled, leaving AIG with a virtual CDS monopoly.

I don't think the new leadership of AIG knew what it was doing. The leverage was huge and the premiums were tiny relative to the risk. Like much of the root of the problem of the financial crisis, everyone operated on the premise that housing values would never go down. Well, of course, they eventually did, and when that happened AIG could not back the CDSs that it underwrote. A house of cards, built on leveraged debt, collapsed in spectacular fashion in the biggest Black Swan event that we will likely ever witness in our lifetimes.

Had Eliot Spitzer not kicked Hank Greenberg out of AIG, the collapse in CDS would have been far less likely. Instead, the desire for a fatter AIG bottom line and thus bigger bonuses driven by the government caused the auto insurance CEO and his greedy executives to trigger the spectacular collapse in the CDS market and every debt instrument tied to it.

Now, I know what you are about to ask. *Why didn't the financial media report on how government meddling into AIG triggered the 2008 financial crisis?* Well, at the time, Eliot Spitzer was profiled as a hero against the

evil Hank Greenberg and all the other demons on Wall Street. In fact, the financial media was so obsessed with glorifying Eliot Spitzer that it helped him subsequently become elected New York Governor, before having to resign in disgrace due to his speckled personal life. The truth of the matter is that the financial media, like much of the news media, has an agenda. The media likes to sensationalize and materially mislead the investing public rather than expose one of its heroes at the time, namely Eliot Spitzer, for helping to systematically destroy AIG and Hank Greenberg. It reminds me of a quote I recently came across: "If you don't read the news you are uninformed. If you do read the news you are misinformed."

Structured Investment Vehicles (SIVs)

SIVs were pioneered by Bear Stearns and Lehman Brothers, but other major financial firms, such as Citigroup were also major SIV players. Essentially, an SIV is a leveraged arbitrage bet on the Treasury yield curve. Specifically, the creators of SIVs liked to sell leveraged one-month Treasury securities to buy one-year or longer Treasury securities to try to profit on the yield curve spreads. Mechanically, SIVs were typically leveraged 10 to 1. They were secured by CDSs and packaged in offshore commercial paper. This is legally a money market instrument that is commonly used for corporate cash management and widely held in money market investments.

Essentially, SIVs were an exotic way to potentially profit from the yield curve and to attract short-term money market assets with extraordinarily higher yields. Initially, SIVs were an institutional cash management product, but when they blew up in the spring of 2008, the bankruptcies of Bear Stearns and Lehman Brothers were not surprising. However, later in 2008, the big surprise was that the biggest money market fund in the country held SIVs, so its Net Asset Value (NAV) broke \$1 per share. This was unprecedented for an investment seen to be as safe as cash!

Most state cash management accounts were unwitting victims of the SIV crash that sank Bear Stearns and Lehman Brothers. As an example, the State of Florida lost approximately \$2 billion in its cash management account for various municipalities. Ironically, former Governor Jeb Bush worked for Lehman Brothers at the time. In defense of Jeb, Lehman Brothers had infiltrated virtually all state houses with ex-leaders in both major national parties. Had Jeb had more success in his presidential bid, I believe his Lehman involvement, and the State of Florida's \$2 billion hiccup would have been headline news. Since he dropped out of the race, he was spared a major public embarrassment.

Clearly, major Wall Street firms have infiltrated our political parties and state houses. It was especially interesting that Treasury Secretary Hank Paulsen

allowed Bear Stearns and Lehman Brothers to go broke via SIVs back in 2008. But eventually the federal government stepped in and decided to save other major firms that were deemed “too big to fail.” Citigroup also messed up with SIVs, but the former Treasury Secretary, Robert Rubin, conveniently worked for Citigroup. Unsurprisingly, Citigroup was also deemed “too big to fail.” Since both Hank Paulsen and Robert Rubin worked at Goldman Sachs together, we can assume that they knew each other well. Furthermore, as a respected Treasury Secretary in the Clinton Administration, Robert Rubin has vast connections in the federal government, especially at the Treasury Department and Federal Reserve. Clearly Rubin was instrumental behind the scenes in the push to deem Citigroup and other major banks as “too big to fail.”

Back in 2008, the Federal Reserve Chairman, Ben Bernanke, got noticeably upset anytime AIG was brought up. The truth of the matter is that Ben Bernanke, like his predecessor at the Fed (Alan Greenspan), Robert Rubin, and Hank Paulsen were all surprised by the epic collapse in CDSs via AIG. New York Attorney General Elliot Spitzer, motivated by his hatred for Hank Greenberg, was behind the management purge at AIG. Ironically, this fact was the beginning of the collapse of AIG and the CDS market. I suspect that Eliot Spitzer to this day will deny that he had anything to do with bringing down AIG. The truth of the matter is that the lack of familiarity with CDSs by the management successors to Hank Greenberg at AIG made the company a disaster waiting to happen. They had no idea that what they were doing could have caused the collapse of the CDS market that took down SIVs and other leveraged debt products.

Leveraged Bond Products

Speaking of leveraged debt products, I witnessed *first-hand* how the Falcon Funds and other leveraged bond products collapsed massively in 2008. The Falcon Funds were pushed by Citigroup’s Alternative Investment Division at the time. They were a disaster, since back in 2008, investors lost 97% of their money in bond products that were leveraged approximately 8 to 1. Many of my neighbors in and around Palm Beach, Florida like to brag about their investments.

Essentially, Citigroup’s Falcon Funds leveraged municipal bonds 8-to-1. Naturally, the investors that I know bragged about their extraordinarily high tax-free returns. However, I am very suspicious of the boisterous crowd in and around Palm Beach, since they seem to always gravitate to investments that are too good to be true. I guarantee you that the investors I know in Citigroup’s Falcon Funds had no idea that their municipal bonds were so steeply leveraged. Since Citigroup’s Falcon Funds, like SIVs, were secured with CDSs, as the CDSs failed, the Falcon Funds and SIVs failed too in a domino effect.

Essentially, what happened in the final four months of 2008 is that an estimated \$1 trillion in corporate and municipal bonds were sold due to a “Black Swan” event. As CDSs failed, there was “forced” bond selling. Any time traders see a wave of selling coming, they drop their bids, so there was a horrific corporate and municipal bond massacre that persisted for four months. All leveraged debt, including Citigroup’s Falcon Funds, were unwound with panic.

In the end, Citigroup’s Alternative Investment Division lost a mere \$21.1 billion in 2008, largely due to the fiasco of the Falcon Funds. The head of Citigroup’s Alternative Investment Division lost his job due to the massive loss that his division posted. That gentleman who ran Citigroup’s Alternative Investment Division back in 2008 was Jack Lew, who subsequently became the Treasury Secretary for the Obama Administration. I can confidently say that Jack Lew now understands the danger of leveraging debt and the fragile CDS market. However, I remain amazed that the financial news media never pointed out that Jack Lew helped to collapse Citigroup back in 2008. To Jack’s credit, there is no doubt that he reached out to Robert Rubin and other influential people to get Citigroup on the “too big to fail” list thus ensuring its rescue by the federal government.

The Danger of Leverage

If there is one thing I want you to have learned, it is that leveraging debt is bad! SIVs were leveraged 10 to 1 while Citigroup’s Falcon Funds were leveraged 8 to 1. So if you ever suspect that your fixed income investments are leveraged, my advice is to run! Fortunately, I have not seen massively leveraged debt since 2008, so the immediate danger of another financial crisis is now far less likely.

The closest thing to another 2008 that I have witnessed lately was on August 24, 2015. This was an intraday “flash crash” that was exasperated by what...? Yep, you guessed it, leveraged investments in high dividend-yielding stocks. What really happened is that some of my neighbors in Florida decided to borrow on home equity loans as well as utilize margin debt to use leverage to buy higher-yielding dividend stocks. This was a total fiasco back on August 24, 2015. You may think that stocks can’t be leveraged anywhere near CDSs. But let me show you how leveraging just 2 to 1 can still destroy your portfolio.

The first example is the iShares Select Dividend ETF (DVY). This ETF quickly plunged over 30% intraday on August 24, 2015 before recovering most of its losses later in the day ... see chart below:



Source: yahoofinance.com

The second example is KK&R Company L.P. (KKR) . It plummeted over 54% intraday before recovering most of its losses later in the day ... see chart below:



Source: yahoofinance.com

What contributed to these wild intraday swings was a large, liquid, dividend ETF and popular dividend stocks. In 2015, some investors thought that it might be a good idea to borrow on margin to buy more high dividend-yielding ETFs and stocks. With such low rates, money piled into dividend stocks. Next came the “margin calls” as prices collapsed. Ouch! A set of seemingly safe income securities were leveraged and got out of control. Can you see how leverage can hurt even conservative dividend investments?

Conclusion

The bottom line is that if Wall Street knows that investors are on margin, they will all too often try to “squeeze” those investors, just like some unscrupulous traders did on August 24, 2015. They “picked off” investors that were leveraged in conservative dividend ETFs and stocks. Remember those Palm Beach investors that boasted of their returns in the Falcon Funds? Well, I should add that I have some retired neighbors in South Florida that bragged how they were leveraged in high dividend stocks back in 2015, especially Master Limited Partnerships (MLPs) and Real Estate Investment Trusts (REITs). But, they had a look of shock on their faces after August 24, 2015 and sadly some even had to sell their homes, because they were so devastated by margin calls on their high dividend stocks.

I believe the true story of 2008 was essentially institutional margin calls on leveraged debt products (e.g., SIVs and leveraged bond portfolios) as the CDS market collapsed. I think it’s obvious that the government caused the eventual collapse of the CDS market by kicking Hank Greenberg, the Chairman of AIG, out of his own firm. The government could not find another competent and qualified CEO to run AIG and actually made matters worse by mispricing CDSs. Consequently all the investments tied to CDSs subsequently failed in a spectacular “Black Swan” event.

A Black Swan event is defined as being totally unprecedented and not expected to occur for hundreds of years. On Wall Street, it happens all the time and is usually where many have the exact same trade on. Traders see them coming and then exploit the situation by “dropping their bids” to pick off institutional investors that are forced to sell (unwind) their leveraged investments. It is estimated that \$1 trillion in municipal and corporate bonds were sold in the last four months of 2008 as the systematic selling from leveraged debt investments were unwound as the CDS market collapsed.

Jeb Bush worked for Lehman Brothers after he was the Florida governor and the State of Florida lost \$2 billion on SIVs. This is an interesting coincidence, to say the least. Jeb Bush’s role in the 2008 financial crisis may have been minor, but there is no doubt that he contributed to hurting his family’s Presidential

legacy by playing even a small role. A much more major role was played by Jack Lew who ran Citigroup's Alternative Investment Division back in 2008. He lost an estimated \$21.1 billion in the Falcon Funds leverage bond products! As a reward, Jack Lew subsequently became the Treasury Secretary for the Obama Administration.

Perhaps most shocking is that the financial news media never told you this story. Washington and Wall Street change jobs routinely. There seem to be a lot of executives at large Wall Street firms that eagerly take government jobs. In my opinion, there is no doubt that while Jack Lew was at Citigroup he made moves to help save Citi. He reached out to former Goldman Sachs CEO and Treasury Secretary Robert Rubin and other influential people to get Citigroup deemed "too big to fail" and therefore rescued by the federal government. Bear Stearns and Lehman Brothers lacked these strong political connections and paid the price, collapsing from their leveraged debt products (i.e., SIVs).

You may be in shock to learn how corrupt Washington, Wall Street, and the financial media can be. The financial news glorified former New York Attorney General Eliot Spitzer. I think Eliot Spitzer the hero also ignited the fuse of the financial crisis by systemically destroying AIG by getting rid of Chairman Hank Greenberg. Now you know my version of the truth. The financial media failed you and everyone. They glorified Spitzer, empowering him to take action. His action ultimately brought down AIG, the biggest underwriter of CDSs on the planet. The ripples were felt far and wide and probably will be for generations to come. File this fact away, and remember it the next time you see someone deified in the media!

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