

SKBA CAPITAL MANAGEMENT, LLC

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LIFE IS EXOGENOUS VARIABLES

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"YOU KEEP BRINGING UP EXOGENOUS VARIABLES!" HE SHOUTED.

LIKE *ECONOMIST*, *EXOGENOUS* IS ANOTHER GREEK-ROOTED WORD, FROM EXO, "OUTSIDE, COMING FROM OUTSIDE."

"WHO THE HELL KNEW THERE WAS AN AYATOLLAH?" ARTHUR SAID. "WHO KNEW THE RUSSIAN WHEAT CROP WAS GOING TO BOMB? WHO CARES ABOUT WHOEVER IS IN THE EASTERN PROVINCE?"

"BUT *LIFE* IS EXOGENOUS VARIABLES," I SAID.

FROM PAPER MONEY BY ADAM SMITH, 1981.

Adam Smith, not the 18th century economist but the 20th century commentator, wrote a wonderful trio of books that remain as relevant today as ever – The Money Game, Supermoney & Paper Money. The astute observer will notice that each book is about *money*.

As we work through the current financial crisis, money is the central issue – it is how we keep score of what's going on in the economy. At SKBA, we seek to understand the current crisis from three perspectives: the standards for getting money (credit), the availability of money to those who meet the standards, and what people expect to be able to do with the money. These perspectives address underwriting standards, credit availability & capital adequacy, and finally consumer & creditor expectations.

To begin with, we are working through a credit crisis driven by the recent degradation of underwriting standards. The sub-prime mortgage market is simply one of the markets where underwriting standards degraded. Other markets include commercial property, leveraged buyouts, prime brokerage, and OTC derivatives. All these markets should be expected to contract, and it is unlikely that they will contract in an orderly fashion.

So how were credit standards degraded?

There are two important elements in the degradation. The first was the expectation of stability, or stable growth. Many commentators have discussed the destabilizing effect of expected stability – where an expectation of stability leads to increased leverage & risk taking, as described in the work of Hyman Minsky, and the Minsky Journey. A simpler, or perhaps analogous, construction of this is simply Gresham's Law, which describes the debasement of currency – a phenomenon which also appears to be in play. The link between Minsky & Gresham is that Gresham's law is about the debasement of currency while Minsky's Journey is about the debasement of credit standards. So in its simplest form, Minsky is an update of Gresham taking credit into account

The second contributor to the degradation was financial innovation -- or doing what all the cool kids in cufflinks were doing. One of the most dangerous innovations was and is the credit default swap. This is because credit default swaps are actually an

insurance product that was improperly priced -- specifically failing to price in counter party risk.

This is a fairly complex issue, but the basic idea is that when you buy an insurance policy for your house you are concerned about the ability of the insurer (the counter-party) to accrue reserves and to pay for losses. In the credit derivatives market, however, people didn't worry enough (or perhaps at all) about the ability of the counter-party to pay. No one reserved for losses since no one planned to lose on their trades, and additionally, no one expected that even if they won on their derivatives trade, that their counterparty might not be able to pay -- so that in a market where everyone thinks he or she will win, everyone could end up losing. This is a gross oversimplification of the details, but accurate in substance.

[A preference for precision over accuracy was & is another general issue, but that can be discussed at length another time – for now we simply want to remember that a key quality of financial innovation has been precision, even if the resulting conclusion is “precisely” wrong, which has precisely lead us to where we are today.]

Since the overall cost of debt in the market was being priced off of the credit derivatives market that was ignoring important risks, interest rate quality spreads were driven to levels that similarly ignored these risks. Markets are currently in the process of working out the underwriting and risk pricing issues, and everyone is certainly now aware of these risks. As a result the price of risk has taken a sharp turn higher. The U.S. economy may or may not do a good job working these problems out, but the market is grappling with these risks now.

What is still beyond the market is what to expect from the changes in these exogenous variables that are not only outside of anyone's control, but outside of the scope of what many market participants are able to think about – *by ignoring exogenous shocks, many participants (generally the ones who like to think of themselves more as*

“players” than “participants”) structurally underestimate the range of potential outcomes.

Underestimating the range of potential outcomes and overweighting recent data are two well documented behavioral biases, which have found their way into every financial model which uses only near term or relatively recent data. *Every historical quantitative model, from mutual fund star systems to value-at-risk models, fails to take into account the future exogenous shocks, or surprises which happen in real life.*

So how do you prepare for the shocks & surprises?

Simple: **Look** at a longer time horizon, and **think** about how people live their lives and whether they will need what you are investing in across the range of possible and probable outcomes -- nothing magical or mysterious. We refuse to replace thought and judgment with a model, and strongly believe that those who do so rely much too generously on the kindness and habits of strangers.

Our process involves neither stochastics, standard deviations, nor even black swans. *It is just the careful study of business over an extended time frame – the kind of stuff which is difficult and unfashionable.*

At least, this is what we do at SKBA, and how we attempt to position the portfolios to profit from the inevitable exogenous shocks & surprises of life. The process has worked well in previous economic cycles and we have high hopes for continuing to build our clients' real wealth well into the future.

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