

# The Credit Crisis: It's All About Liquidity

*By Richard Croft*

*March 14, 2008* – On Tuesday the CEO of Bear Stearns went on national television (CNBC) and stated, for the record, that the company had “sufficient” liquidity. Two days later, Bear Stearns approached its clearing banker, JP Morgan Chase, and requested it seek capital from the Fed’s discount window, which it did, with an injection from the New York Fed.

This quickly became public information. For one, JP Morgan Chase wanted to make certain that everyone knew it was not seeking the capital for internal purposes, but was in fact seeking the capital on behalf of a client, namely Bear Stearns. In the financial business, perception is reality.

Some points of clarification are in order. Some might ask why Bear Stearns would take this step when, as a primary dealer, it would have access to the \$200 billion swap announced by the Fed earlier in the week. The reason: The swap was not available until the March 27, and clearly Bear Stearns could not wait.

So why then, did Bear Stearns go hat in hand to JP Morgan Chase? Why not simply talk to the Fed on its own? The reason: Bear Stearns is not a bank, and it did not have access to the Fed’s discount window. JP Morgan Chase, its clearing bank, does.

So much for the background. What is clear is that the real problem is liquidity. Even for AAA-rated commercial paper, there is no readily available secondary market. It is not a question about credit quality. If you are in a position to hold the paper, you will earn the regular interest payments and will get your money back when the paper matures. The problem is that many players are not in a position to hold until maturity.

Think about it this way. Suppose a giant hedge fund leveraged at say 32 to 1 gets a margin call on its portfolio. It is holding AAA debt, and it has priced the debt on its books at par.

The margin call requires the hedge fund to come up with capital, or the primary broker will sell the assets at whatever price it can get. The hedge fund is not able to meet the margin call and has to sell assets at whatever price it can get. Let’s say it sells at 95 cents on the dollar. That becomes the new price for the paper. Now let’s say another financial institution, like Bear Stearns, has to re-price the same paper, which it also holds on its balance sheet at 95 cents on the dollar. It now has to sell before March 27, so that it can stay in business and continue to act as a counterparty to other financial institutions, the counterparty business being, well, its primary business. That causes another re-pricing, and the cycle begins again. Do this enough times, and the house of cards collapses.

Under this scenario, interest rate cuts will not by themselves, solve the problem. Leveraged hedge funds cannot maintain their positions whether they are borrowing

margin at 3% interest or 1% interest. They will still get a margin call and will still have to answer the margin call.

The Fed was obviously trying to short-circuit these problems by offering to swap liquid Treasuries for AAA commercial paper – just not in time to save Bear Stearns. And that speaks directly to the speed at which these problems surface.

On the positive side, the Fed was willing to step in and save Bear Stearns. That implies for the moment, that it is not willing to allow Bear Stearns to fail – just yet. But that is what will most probably happen in the weeks, and perhaps, days ahead. You also must understand that blood in the streets creates opportunity, especially for investors with cash on the sidelines willing to step up to the plate and judiciously buy when everyone else is selling. We are in that position.

The opportunities I speak about rest with the ability to hold quality debt without having to sell, which is to say, holding unleveraged positions. At Croft Financial Group, the bonds held in our portfolios are investment grade, and the bulk of these debt instruments are in government Treasury bills and Treasury bonds.

I might add, that the biggest US position in our pools is long-term US government bonds, which rose by more than 1.5% today. We are also holding approximately 20% of our pool assets in cash as in Government of Canada Treasury bills, none of which is leveraged.

With cash on the sidelines, we are seeking opportunities to buy distressed debt of excellent quality, which we would be prepared to hold to maturity. We are simply not willing to make those commitments...yet.