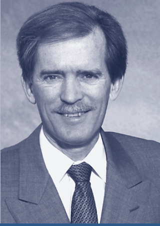

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Investment Outlook

PIMCO

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J.P. Morgan and Character – The Third Edition

Lending is not based primarily upon money or property.
No sir. The first thing is character.
— J. P. Morgan

OK J.P. you win. Oh swashbuckling Wall Street raconteur of century past. You with the bulbous nose whose portrait sits behind my office desk, watching my every move, snickering at my mistakes, lauding my tortuous progress. You Sir, were right after all. Character, not assets, should be the foundation of lending. I've resisted your ghostly advice for many a year now, even though your words above have been the theme for at least two of my *Investment Outlooks* over the past decade. Problem was, even though they have the ring of profundity to them, upon closer analysis they imply that the ideal lender should be more of a shrink than a green "eye-visor" accountant. Hard to be a shrink when you manage $280 billion and lend to literally thousands of companies. You'd need a king-size couch occupied 24 hours a day to stay on top of it. But now as the world and the worm turns and we come full circle back to the days of early twentieth century robber baron capitalism, I find your advice more and more sage. What the financial world needs now are more shrinks and fewer accountants.

I actually became a true blue J.P. convert only a few days ago I think. Watching the market value of $2 billion of our Sprint bonds decline a point per hour in the wake of continuing accounting scandals, I turned to Jim Keller our government specialist and said, "You know the difference between ENRON and Sprint, Jim? It's Bill Searcy." Now Bill Searcy, the pension and savings trust officer at Sprint, is probably not well known to most of you but he is to us. Since Sprint is a PIMCO client, Bill has been in our offices with regularity over the past 10 years, with the intention of putting us on his Morgan-style couch. In the process though, I've learned something about him and Sprint as well. I've learned he's intelligent, hardworking, upfront, honest and trustworthy. A man deserving of being an Eagle Scout, even if he never was one. And I've learned in the past few month's discussion with Sprint's financial managers that they're pretty much cut out of the same mold. They appear to have, as J.P. might have surmised, – "character." There's nothing ENRON about them.

Now before you think I've gone over the edge, let me emphasize that there's a place for both shrinks and accountants in this New Age world of lending. I don't care how nice you are: if your company has too much debt, is without a viable business plan, and encamped within an industry riddled with capitalistic excess, you're goin' down baby. So most of those

things we learned in business school are still important: debt/equity ratios, interest coverage, industry analysis – everything but EBITDA that is. Seems Warren Buffett was right on that one when he said EBITDA was all a bunch of hooey. But to this mix it's gonna pay to add a dose of character analysis in order to find the survivors. And because there are literally thousands upon thousands of corporate borrowers out there, and not enough time in the day, or people in any organization, to play Sigmund Freud, maybe just a healthy dose of common sense will do. Like valuing conservatism, instead of aggressive growth in a company; finding credits that didn't always seem to beat Wall Street estimates by a penny a share quarter after quarter; shunning corporations whose CEOs are the cover boys and cover girls at bookstore magazine stands; management that hasn't resorted to outlandish option grants and paid themselves tens of millions per year. Things like that. Corporate if not individual character analysis. Common sense, not star worship.

Actually, I like to think that we at PIMCO have applied a lot of that in recent years to our corporate bond selection despite recent market losses in some of our telecom purchases and yes – more than $200 million WorldCom bonds. We've known that rapidly changing technology and a shift from regulation to deregulation in the energy and telecommunications industries were anathema for corporate bond holders. Winners pay off at par in the bond world and losers sink to – well 15 cents on the dollar, as was the case with WorldCom. Not a very attractive risk/reward ratio I'd say. That well publicized PIMCO policy and the forecast of a recession in 2001 kept us out of corporates for several years when the competition was falling all over each other to buy anything with a spread over Treasuries that didn't say "mortgage." Our jump back into the corporate pool this year was just that – a jump into the shallow end and not a plunge from the 10-foot board into the unknowns of the deep water. Still, it was no doubt premature. We perhaps failed to wait the customary hour after eating our competitors' lunch before getting wet again.

Swimming metaphors aside however, there remain substantial problems in corporate-land even if an investor uses financial ratios, common sense, and an occasional shrink or two to make decisions. There's overcapacity everywhere – not just in telecoms – and too much debt on the books of most corporations: a sometimes deadly combination, especially in an anemic global and domestic economy. And there remains the overarching negative of rapidly changing technologies in a technology driven world. Schumpeter's creative destruction lives on, no matter what the pace of economic growth. Add to these the recent accounting scandals leaving bondholders to wonder exactly who is or isn't a solvent company and you have a recipe for disaster.

But there are fresh negatives to haunt the traditional corporate bondholder that emanate from the growing power of hedge funds and their willingness to play fast and loose with the solvency of struggling companies. Let me say at the outset of this thesis that I have little proof. No hedge fund has admitted their machinations to me. My corporate specialists and I, however, see things

every day now that were not happening several years ago. We hear the rumors. We might, just might be on to something so take it for what it's worth: a Maybe with a capital "M."

The game is played as follows: Just as lions cull the weakest and slowest from the Zebra herd, hedge fund managers prey on disabled or temporarily injured companies by shorting their bonds. Corporations with high debt levels, SEC investigations, accounting improprieties, earnings shortfalls, or other blemishes are the obvious targets and perhaps rightly so. Shorting is a legitimate form of arbitrage and an age-old investment technique of sophisticated investors. They help to keep the "herd" of corporations healthy, if only by rapidly adjusting prices and signaling to the market and management alike that something might be amiss. But while this works efficiently with stocks, the technique has more destructive power in the bond market than may be healthy over the long run. The reason for the difference is that bonds are divided into two distinct groups: investment grade and junk. Many institutions and investment managers are limited by law, fiat, state regulation, or simple internal guidelines to the higher quality Baa and higher spectrum, so that in the case of a downgrade to junk status they are "forced" to liquidate.

Knowing this requirement for forced institutional sales at the stroke of a downgrade, hedge funds find the vulnerable Baa Zebras and begin the chase. Selling bonds holds little near term risk because of these companies well publicized problems, and once they get prices moving by one, two, five points on the downside they solicit an unsuspecting innocent ally in their game: the rating agencies. Hedge funds and everyone else for that matter, know S&P, Moodys, and Fitch are extra sensitive to the perception that they moved too slowly with ENRON and other corporate rating disasters. They know that the agencies watch bond prices and bond yields in addition to a myriad of other indicators as a clue to the quality of a corporation's debt. And so by pushing a company's bonds down in price and up in yield they sometimes, SOMETIMES, can initiate an agency downgrade into the world of junk bonds and out of the world of investment grade which in turn precipitates the forced liquidation of some institutional holdings. The hedgies can now do one of two things: they can cover (buyback) their shorts at prices 5-10-15 points lower due to the downgrade or they can press their bets – selling a few more in a frightened and illiquid market – and hoping for further downgrades by the agencies due to the negative price action. Either way, in the midst of accounting scandals, legitimate SEC and government investigations, and a genuinely negative PR environment for corporations, the game results in billions of dollars of profits for the hedgies.

So is this a bad thing? Buyer (or seller) beware you say and I'd agree. This is not a Poor PIMCO or an George Romney "I've been brainwashed" thesis. But it's a heads up to corporations and investors alike that due to the increasing clout and financial firepower of hedge funds that the game has changed in the past few years. In addition to traditional credit – and yes J.P. – corporate character analysis, investors must now factor in a momentum driven, Soros-like reflexivity

behavior into their portfolios of corporate bonds. If you can't handle a downgrade to junk status, perhaps Baa rated bonds should be off your plate as well. And corporate CEOs and Treasurers should understand that the fate of their company lies not just within, nor even with their increasingly reluctant-to-lend bankers, but with bond holders and the hedgies that are beginning to dominate the financial and investment horizon. Once downgraded to junk, it's a long road and a long time back to the promised land of investment grade. Corporate survival and access to capital will undoubtedly be jeopardized because this is so.

Corporate bond prices and yield spreads are also being seriously affected by the withdrawal of banks from the short-term lending arena. For decades, bank "lines" have been a standard foundation for the commercial paper market and a perennial piece of banking business that was tied to underwriting fees for investment banking subsidiaries. As such, the "lines" were in many cases granted for "free" or without pricing consideration as to their inherent risk. Longer-term corporate bond valuations were explicitly tied to the granting of these lines and the subsidy pricing. In short, narrow corporate spreads in the late 1990s/early 21st century were artificially low because bank "lines" not only were available but represented little cost to the borrower. Now these lines are being withdrawn or drastically reduced even for high quality corporations, forcing companies to term out debt and pressuring yield spreads wider. In addition – and this is critical – the remaining lines are being hedged by the sale of "credit default" swaps. These swaps are overwhelming traditional corporate bond buyers based on the sheer dollars of supply, blowing out spreads on the front end of the credit curve and pressuring intermediate and long term spreads in the process. To state the problem succinctly – the corporate lending market has lost a huge supplier of funds as the banks have begun to recede from traditional lines of business. The vacuum can temporarily only be filled by much lower prices and wider yields that attract cross-over buyers from stocks and high yield constituencies.

Together, the arbitrage activity of hedge funds and the withdrawal of banks from the short-term lending market have devastated corporate bonds in recent months. Bond managers should do several things: First they should recognize that yield spreads will not return to the narrow levels of yesteryear no matter how strong an economic recovery we have. Secondly, they should find those corporations with attractive long-term fundamentals and J.P. Morgan-like "character" and stick with them. There is a high degree of irrationality in some areas of the market at the moment (Sprint, ATT, selected energy companies) due to these new age corporate bond market realities. The task is not to whine or complain but to find the healthy Zebras with sound body and stalwart character and survive to manage money another day. After all, it always has been a jungle out there, now hasn't it?

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