Mr Edward Misrahi is responsible for Eton Park's European and Emerging Markets activities. The following is a speech Mr. Misrahi delivered at the Finance Forum at the Centre for Jewish Life, on 29 October 2008

Introduction by Yosef Vogel

Welcome to the Centre for Jewish Life. We read this week in the Torah the two stories of the Flood and the Tower of Babel. We are told the Flood was punishment for the outrage and corruption of that generation, and similarly the hubris of the Babel Tower once again provoked punishment. Clearly, however, the Flood was a much more severe reaction than that to the Tower of Babel, when God acted merely to disperse them.

The biblical commentaries express puzzlement as to why God let the arrogant Babylonians off the hook so lightly when their efforts, after all, amounted to deicide. The commentaries conclude that it was the Babylonians' *strong unity* that inspired God to merely frustrate their plans, so impressed was he such unity. Generation Flood, however, possessed an X factor that placed them beyond salvation and that was their extremely perverse behaviour *toward each other*. We can easily draw inspiration from these Torah stories for our own times and strengthen our personal and communal relationships.

I want to introduce you to our speaker Mr. Edward Misrahi. Born in Spain, he studied at Princeton University and then went to work for Goldman Sachs. He later founded Eton Park, with Mr. Eric Mindlich, and they developed a very successful hedge fund. We look forward to hearing what he has to say.

Edward Mizrahi

When I agreed to give this talk four or five months ago the market was not yet as bad as it is today. A lot has changed since then and very, very quickly. In fact, when I recently began to prepare my speech, I decided to wait until yesterday to finalize it, just in case it would have become outdated by today.

These past five months have been a roller coaster for the financial sector and, unfortunately, the roller coaster is moving through the rest of the economy too. What happened? I'm not qualified to talk in depth about real estate, structured credit and rating agencies, so I will keep my remarks general, try to provide some context, and outline what is going to change. I will not be making market predictions.

We at Eton Park didn't anticipate the scale of this downturn but we have held a very negative outlook for a while. It seemed to us like the Titanic after hitting the iceberg. Most people in first class keep listening to the violin and continue dancing in the ballroom, unaware of the water flowing in. Similarly, these market events appear very sudden but in truth they have been a long time coming.

I will touch on three areas, beginning with some background to this crisis. Secondly, as this crisis has developed in stages and will be solved in stages, I will talk about which stage I think we are up to today. Thirdly, this crisis will have major implications for the future and I will outline what some of these may be. I also want to clarify the role hedge funds have played in these events as they tend to get unfairly blamed for many things.

Giving context to the crisis: bubble logic

What we are seeing today is simply the implosion of a massive bubble. It's very unpleasant, but not more complicated than that. People may have many different explanations for what happened, but very simply put, we witnessed a massive, worldwide credit bubble.

As context, I'll offer some US statistics and bear in mind the UK faced similar dynamics. During the past ten years, consumers and the financial sector have been the two most highly leveraged sectors in the world. Leverage in the financial-sector multiplied by six times since the early-to-mid 1990s, while doubling in the consumer-market during a similar period.

Such a state of affairs comes about slowly and over a long period of time. We can retrace these steps as they were gradually taken toward more and more heavily geared positions. Every time you increase it you do so only slightly and feel justified in doing so because, well it's only a slight increase. But with time, these small increases add up to wholly new levels of leverage and people can no longer take in the magnitude of debt that is supporting trading activity. People eventually go numb at the numbers.

For example, the reference value of Over The Counter (OTC) derivatives - tradable financial contracts linked to other financial securities - grew from $100 trillion to $500 trillion over the past ten years. I don't know how to even conceive such a number but this number was a result of the tremendous growth in the financial industry. The industry's collective balance sheet, the net total of all the balance sheets of every major investment bank plus all 2,000 hedge funds, ballooned to match half the size of all the worlds' commercial banks put together. How? Through leverage rising from fifteen parts debt to one part equity in the 1990s, to forty to forty five parts debt to one part equity recently and even reaching in some places last year sixty parts debt to one part equity.

Bubbles are not new. They happen again and again and we are always surprised when we see them. During the South Sea Bubble in the UK during the 1700s, speculators purchased a lot of joint stock companies. Among the many companies to go public in 1720 was one that advertised itself simply as a company 'for carrying-out an undertaking of great advantage, but nobody knows what it is.' Then just as now, people bought over the past five years without knowing exactly what they were buying, simply expecting the value to keep going up.

In 1870, there was a big panic in the United States, following a big bubble fuelled mainly by railroad and real estate. Reading descriptions of that bubble makes very familiar reading. The difference this time is the global impact of the crisis, as the world is now radically interconnected via technology and globalization. I deal with emerging markets, and people there have long wanted to be more like the Western world. Now they got what they asked for, they are now more like the Western world and that is perhaps no longer such a good thing. Contrast this with the famous Tulip Bubble in Holland during the 1600s, where it was really bad in Holland, but probably OK in the US. Talk to friends or colleagues in other parts of the world and you find that everyone feels it. This explains why people feel its exceptional.

A lot of it, especially for the household sector, started in real estate. It started first in the US, but then it spread around the world. The UK was obviously a big beneficiary of it, and there were many benefits from the credit expansion in real estate, but again it became speculative and grew. I remember walking on the beach in Turks and Calgos, a Carribean Island, and seeing one real estate development after another, owned by Canadians, Britons and others. There was an assumption that if you buy real estate anywhere in the world it will go up.

Not the Great Depression

There are comparisons being made to the great depression especially by the press but I think these are misleading. This is ideal material for a sensationalist press and its very important for people to move away from such negativist and sensationalist psychology.

The statistics show the difference. In the 1930s GDP in the US fell 25% in real terms and 50% in nominal terms over five years, and unemployment increased to 25%. One in three people you knew were unemployed compared to today where unemployment in the United States is 6%. The worst projections I've heard for the United States for 2009 is a contraction of 2% whereas during the 1930s, 7,000 banks failed and people lost their deposits. The situation may yet get worse than it is now, but I think things will pick up.

One Step at a Time: A Crisis in Five Acts

This is not very scientific but we can say there are five phases to such crises.

A. Denial

The first reaction is simply denial. In 2007, when news about the US sub-prime mortgage market first came in, people immediately shrugged it off saying it was contained there in the US and would not affect us here at all. The Americans were after all a crazy bunch and overreached themselves as usual. Denial is not just a river in Egypt.

B. Reluctant acknowledgement and a little anger.

Denial slowly gives way to something more complicated. You face reality but hold it at bay at the same time. The problem, you accept, is more serious than you first thought but you continue to wish it wasn't. You believe the fundamentals are strong enough to weather any superficial setback.

Northern Rock, September 2007, is a good example of this. They were a leading mortgage provider and admired for their innovation but that was quickly forgotten. People dismissed the crisis as the isolated failure of an overly aggressive team. The facts of the crisis were admitted but its' meaning was ignored.

C. Bargaining and recognition,

Then you realise that you may be in serious trouble but this insight is blunted by ten years of good memories, and such baggage is too heavy to free yourself from instantly. You decide to make a few, slight changes and hope it will be enough. But of course, it isn't.

D. Reality and panic,

This was in evidence during the past few months. The underlying problem was already there, it didn't suddenly happen. Instead, reality suddenly hit people and they panicked.

Government goes through similar phases but faces a special conundrum when it does hit reality. It can either share in public panic and feed it as it does so, or not show panic and let people suspect it lost its grip.

E. Healing and recovery

This is the final phase where all these problems get worsted out. Healing, effectively, means de-leveraging. People reduce their debts and create the basis for recovery, both for companies and individuals.

I think we're at the crux between phases four and five. People asking if the bank is a safe place to put their money is panic at the nth degree, as they feel they cannot depend on the ATM machine to work. But we've passed that maximum point of panic.

In the financial sector, banks were not lending to each other. The corporate sector was paralysed because many businesses, especially small and medium sized businesses, could not get credit to make purchases.

Government is committing trillions of dollars to fix the problem in Europe, the US and the UK. These governments are at the forefront of efforts to protect depositors from bank failure. When people worry about the banks, that is a red flag and you better do your damnedest to repair confidence. That lesson was learned from experience in the Great Depression.

They've tried to unfreeze the banking market and get banks lending to each other again. We see the stock market is still very volatile but the panic from several weeks ago has calmed down. I don't think we're completely out of it but conditions are in place to get there.

Also, people believed that once the panic died down everything would go back to normal. There is disappointment that markets keep falling, people are still losing their jobs, the economies don't look better, even though government has done all these things. This is happening because panic resolution is a necessary but not sufficient resolution. Similar to a fire in a museum, where pouring water on the fire will ruin the paintings. You cannot save the museum as well as the paintings.

Some of these companies that are being closed down will recover but they will not be as strong or as big as they used to be, and therefore they won't be able to do everything they used to do, or hire as many people.

Additionally, you have a situation where the patient, in this case the economy, has only been able to get to the hospital altogether because the government sent the ambulance to bring it in.

This reminds me of taking my son to a hospital when he tore his lip. After they took care of him I asked how to pay? In the US, there's no equivalent to NHS. Go to the hospital there and the first thing they ask for is your credit card.

But the difference between the NHS and Government is that Government is not going to do it for free. They're going to want to extract something. It's going to come in the form of incremental taxation and especially, incremental regulation. In summary, we've come from a very tricky place and we're now at the beginning of recovery. It can take a while, but at least we're starting to heal.

Implications for the Future: A Shrinking Horizon

Some of the implications for the future obviously begin with the financial sector itself. It got too big and unsustainable. It's going to shrink.

Moral Hazard

To understand this better, let's talk about moral hazard. This concept was developed by insurance companies to name something they observed about their service. Effectively, they were encouraging more risky behaviour on account of the very protection they put in place against that risk. They found that holding a fire insurance policy, for example, made a client more likely to smoke in bed.

Applied to finance, moral hazard assumes massive proportions. Fire spreads more quickly through the world of finance and is harder to put out.

In 1998, Long Term Capital Management, a hedge fund packed with the best brains in finance, faced collapse and was bailed out because government felt it would cost less to save it then to let it fail. Since then moral hazard has become embedded in finance. When central banks slashed interest rates after the dot com bubble, leverage grew and the position that markets can regulate themselves took a fundamentalist turn. All this makes highly combustible material.

In finance, moral hazard has a peculiar mechanic. People start to believe that any increased exposure is offset by the higher probability that it will not be allowed to fail. This produces a perverse result where the more irresponsible the trade, the more favourably it is viewed. Investors found the game safer to play, the more structural risk they assumed.

The UK too, experienced a big real estate boom over fifteen years. Buying property in 1996 seemed a risky thing to do even though property was much cheaper than 2004 when it seemed like the safe thing to do. Perceptions of safety are highly sensitive to framework. This created a dynamic in the market where people said, let's not worry.

In my view, the culprit is the former Chairman of the Federal Reserve, Alan Greenspan, who mishandled interest rate cuts.

The financial system is to the global economy what arteries are to blood circulation. It is essential to protect it. But the system outgrew its function. As an example, when I graduated from Princeton very few graduates went into investment banking, many more into management consulting. Lately, the trend inversed, and finance was the favoured choice. This was fuelled by greater moral hazard.

Lehman Brothers, unlike Bear Sterns, was allowed to go bankrupt and that was a shock to the system. Perhaps they were allowed to go bankrupt because they were legally unsalvageable due to lack of assets. In any event, people were suddenly confronted with this loss of protection of last resort. Investors has spent a decade investing a certain way, and now the carpet was ripped from under their feet.

To prevent this from happening again regulators are going to increase regulation across the financial board. They are not going to let people get that big anymore.

This countervails a trend in the UK, where diminishing industry pressured finance into assuming a special role. Now, they are going to prevent a situation where a firm goes down and takes everyone else with them. Such regulation will tend to hamper creativity and so people will have to stay lean.

There is a lot of volatility in the markets today. No one really knows what's going to happen next year. The investment frameworks that people have used for a decade are now obsolete. It's not going to be as good as it used to be. What do you do? You become more conservative and you take less risk. Prices will fall. People just don't have the same faith.

The Role of Hedge Funds

Hedge funds are no different than other businesses. Their job is to manage people's money and if you do your job well, you do well yourself. It's been a very lucrative economic model, partially because people made a lot of money for their investors. No one in the hedge fund industry has made a lot of money just because they were in the hedge fund industry. It is true however that the structure of the industry created asymmetric risk, i.e. the investors assumed more risk than the managers.

Hedge funds look for opportunities across markets, asset classes and geographies. They buy and sell these assets and take both long and short positions. They try to find situations where something doesn't look right and when they find it they base a trade on it. If they think a bank has made bad loans, they short the stock of the bank, predicting the bank will lose money and the stocks' price fall in value, not because they want the bank to go out of business.

If some hedge funds behaved illegally they deserve to be prosecuted. I think people in the hedge funds are generally on top of it and are a mix of good and bad sorts just as in other industries. Hedge funds have perhaps been conspicuous by low levels of disclosure. Some have been incredibly successful, which screens the amount of sympathy that you can have for them. But to blame the crisis on the activities of hedge funds is basically just to pick one of the players involved.

The real origin of the problem was simply that financial companies, including hedge funds, lent too much money to too many people for the past decade, and in many cases, recently, to a lot of people who hadn't prayer of being able to pay it back. The hedge funds may have been effective at catalysing the visibility of this dynamic, but they're definitely not responsible.

In the UK, they outlawed short selling. They increased the disclosure of the financial sector and yet the stocks are down even more. It's not the hedge funds that are doing the selling, it's people who own the stock who don't trust the management anymore. Hedge funds simply find other ways to make money and to blame them for what happened is convenient but misguided. You could do a lot of things to hedge funds and the crisis will still happen the same way.

Adapt, Have a Tonic & Keep it real

I think it's very important for people to keep the situation real. The situation is bad but it's not the Great Depression, nor the End of the World. We've had an incredible run for a long time and that is now over but compared to real economic hardship, we're much better off. It's vital that we don't talk ourselves into a paralytic situation where it becomes impossible to act. Action and a balanced perspective matter.

The world has changed and it's just not going back to where things were. The changes that are going to happen will be permanent. It's going to take a while for the cycle to go through again, and therefore it's very important to deal with the situation here and now, the opportunities that are here and now. I have to keen an open mind and ask myself, how do I capitalise on the situation now? How do I get out of this mess in which I am in right now? I cannot wait and procrastinate, I have to be proactive and adapt to the new environment.

The government is going to be much more involved, there's no way around it. Transparency is going to increase. Disclosure is going to increase. People are going to know better what other people are doing. The industry will have less ability to do certain things and we all have to realise regulation will materialize, some of the rules are going to be explicit, some un-written.. The crisis is everywhere and governments are going to get more involved everywhere.

I think that you're going to have to realise that that safety net that people used to think is there, is not there anymore. It's better to work under that dynamic. You can't push the situation of your company or for yourself too much, or do some of the things that historically you have been able to do to help you recover from a bad situation such as thinking that I can refinance this, or I can get another line of credit for that. But crises also create a lot of opportunities, the world's not going to stop, it's going to grow less, but companies are still going to need capital to do things, projects are still going to get done, people are still going to have good business ideas, people are still going to be buying stuff.

Street Smart

In 1994, I was looking at Mexico, which just had a brutal currency crisis, falling from three pesos to the dollar to ten pesos to the dollar. Banks were failing everywhere. Living in New York and reading of financial events in Mexico, you might have assumed that that Mexico would disappear from the map. So I decided to visit Mexico myself. But what do I see at the airport? Plenty of taxi drivers, hotels, streets and restaurants are filled with people. Life goes on and Mexico recovered.

I think it's about the creative dimension, a new beginning for the financial sector. It's going to create other opportunities that are different and you have to try to take advantage of them. Thank you very much for your attention.