The Carnegie Counselor

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Gambling vs. Investing

Lessons from the MF Global bankruptcy

Even a casual reader of the daily news is aware that another Wall Street brokerage firm, MF Global, had to declare bankruptcy recently. Someday Hollywood will produce a movie on this storyline, but to us it is a tragedy resulting in the 8th largest bankruptcy in history that didn't have to happen.

Despite the rise of regulations after the recent financial collapse, this bank lost ~$1.3 billion in client accounts. This is the story where poor regulations, questionable ethics and hubris collide. These are all themes we consider when making recommendations and unfortunately, this is a current real world example of what can happen when you don't.

Before regaling this discouraging story, we'd like to differentiate our service from what transpired. As a brokerage firm, MF Global commingled client accounts with company funds, which we could never do since your accounts are held by an independent custodian. This is no small issue. If every firm separated the management of the assets from the firm that holds the shares and places the trades, many inherent conflicts of interests would be removed. At the beginning of this year MF Global was worth over $1.5 billion, served over 150,000 customers holding $40 billion, had wooed former Goldman Sachs Chairman and New Jersey Governor Jon Corzine to be their Chief Executive and was one of only 22 firms approved to be the selling agent for U.S. Treasury debt. When MF Global was pursuing Mr. Corzine to be its next CEO, other than the millions in guaranteed money, he also demanded one out-clause to his contract. If the President of the U.S. offered a cabinet-level position, then he would be allowed out of his contract. You'd have to be quite self-confident to put that request on the table.

Last year the Commodity Futures Trading Commission had proposed changes to a rule (Regulation 1.25) to protect customer funds, including tighter restrictions on repurchase agreements. In such transactions, the firm swaps customer funds for corporate bonds held at another part of the firm. The firm can book the excess interest as profit and (as we've learned), apparently play a shell game with customer money. On December 2, 2010 MF Global wrote a comment letter to the CFTC suggesting the pending regulation could "decrease significantly the income derived from prudently investing in customer segregated funds". Mr. Corzine strongly opposed the new regulation and on a conference call on July 20 he argued that the restrictions would hurt MF Global and its customers. None of the four commissioners, two Democrats and two Republicans, voted in favor and the new regulation was set aside.

For seven quarters in a row, from late 2009 to mid-2011, MF Global's quarter-end borrowings were an average 16 percent lower than the quarterly average according to *The Wall Street Journal*. Reducing debt levels at the end of a quarter to look financially stronger is called 'window dressing'. While this isn't illegal, it can make financial institutions look stronger than they are and mask risk taking. More than a year ago, the Securities Exchange Commission proposed a rule that would require companies to disclose more about their short-term borrowing, but has yet to take final action on the rule.

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MF Global also down-played its trading risks using a complex transaction called "repo to maturity," pledging bonds to third parties in return for loans with a promise to buy them back at maturity. This enabled the company to take billions in European exposure off its balance sheet by treating them as sales. After the collapse of Lehman Brothers, which used the same accounting trick, the Financial Accounting Standards Board didn't take action to close this loophole. In April of this year, FASB released a statement that

suggested revised guidance had made it substantially more difficult for firms to use off-balance sheet accounting. It stopped short of banning the activity or demanding firms to be more transparent. In 2007, Lehman was leveraged 30 to 1, meaning for every $1 in capital, the company had borrowed $30. In contrast MF Global was even more highly leveraged at 40 to 1, yet the regulators did nothing.

When Lehman Brothers fell, the major ratings agencies (Standard and Poor's, Moody's and Fitch) were caught flat-footed and still had Lehman's debt rated (A) when it filed for bankruptcy. Certainly they had learned something in the interim. In August of this year, regulators released data showing they had required MF Global to set aside more capital against potential losses on European trades. By September 30th, the stock of MF Global had lost half the value from the beginning of the year and was now trading at less than $4/share. On October 25th, MF Global announced a $191 million quarterly loss as Mr. Corzine said the firm's trades "have relatively little underlying principal risk and we expect to deliver for shareholders in the quarters ahead". On October 26th Evercore Partners was hired to find a buyer for the firm. On October 27th Moody's and Fitch were so moved they downgraded MF Global's debt to slightly below investment grade. When MF Global filed for Chapter 11 bankruptcy on October 31, Standard & Poor's still had the firm at 'investment grade' quality. Fortunately for all investors buying Standard & Poor's research, later in the day it dropped the rating on MF Global to 'default'.

Technically, MF Global had to declare bankruptcy because customers were closing accounts faster than the firm could sell assets to provide the requested capital. It was the trading losses the company incurred that started the stampede of customers for the exits. The company bet big on debt issued by European countries. The primary trader was none other than Mr. Corzine, who initiated the trading soon after his arrival. He was convinced the bonds were a bargain and the debts would be paid. Slowly he expanded the trades, doubling-down as the value of the bonds continued to head south. The risk-management division at MF Global was headed by Brad Abelow who followed Mr. Corzine from Goldman Sachs to New Jersey and now to MF Global. If the risk-management team couldn't reel in trading, they could defer to the MF Global board headed by….Mr. Corzine. When the music stopped playing, the firm had $6.3 billion in European bonds, *none of it accounted for on its balance sheet*. Over 33,000 clients of MF Global are waiting to receive access to their accounts out of bankruptcy as of November 18. Sadly, when Mr. Cozine resigned, he had to forego his $12.1 million severance package.

Mr. Corzine took large bets gambling with company and client money, he was not an investor in European debt. We buy debt, or bonds, with the intent and ability to hold to maturity. Commingled assets, such as mutual funds, run the risk of investors fleeing forcing managers to sell assets, so we prefer to use individual bonds and stocks to retain control. We don't bet the farm believing we are smarter than everyone else. Client capital is invested in successful enterprises, growing with a wide moat. We use third party custodians to hold and safeguard client assets. We know the markets are not properly regulated, and likely won't be anytime soon due to the influence of the big brokerage firms. Even strong regulations can be manipulated by people who play fast and loose with accounting rules or have questionable ethics. We appreciate the inherent risks of companies led by people with large egos and too much hubris. We are also realistic to know there are more Enrons, Bear Stearns, Lehmans and Bernie Madeoffs out there that haven't been discovered yet. Investing in the public markets is always a risk; however, sitting in CDs is neither productive nor prudent at this time. We will continue to be your advocate, ever attentive to potential risks, so you can reach your financial goals as an investor.

As a truly independent investment management and planning firm, Carnegie Investment Counsel has a rich history of providing careful and responsible management of your financial assets to reach your short and long-term goals.

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