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WE'RE INVESTMENT BANKERS AND WE'RE HERE TO HELP

In the great financial bail-out, Americans know they're getting a \$700 billion bill for cleaning up a mess made by others. As reluctant buyers in history's largest transaction what they need is, well, an investment banker. Our job is to advise clients about financial transactions – often to help clarify where they stand after closing a complex, “must-do” deal. From that perspective, here's some advice for our fellow taxpayers:

- **You Are the Only Buyer.** Cutting to the chase, you and your fellow taxpayers are buying a vast portfolio of mortgages and mortgage-related securities that are “illiquid and hard-to-value.” That's the technical term for: nobody else wants to buy this paper, in large part because it cannot be priced accurately right now. Leaving aside for the moment whether it's a good idea in the first place, only you and the US Treasury can buy this portfolio due to your outsized power to buy and hold assets. Nobody else can do it.
- **You're Buying Value, Eventually.** The paper you're buying is hardly worthless and will generate cash from mortgage payments and from re-selling parts of the portfolio. But this will happen only when new market prices are established, which takes time.
- **Focus on the Right Price.** With the bail-out a done deal, don't be too distracted by the breath-taking headline number of \$700 billion. What's important now is the price the Treasury gets when it spends your \$700 billion buying up portfolios from struggling banks. Some yardsticks are emerging. Earlier this year the hedge fund Lone Star Funds purchased from Merrill Lynch collateralized debt obligations (CDOs) for \$6.7 billion which had been valued at \$30.6 billion before the crisis (a “fire sale” price of 22 cents on the dollar). Talking to market practitioners and looking at various bank disclosures, we see that many such assets are being valued closer to 65 cents on the dollar. So while your price will depend on the portfolio's specific credit characteristics, it will likely end up somewhere between 22-65 cents, probably closer to 65 cents on the dollar because you can buy and hold.

- **Watch the Auctions, Not C-Span.** In the end, how you fare in this transaction depends more on the Treasury-run auctions than on Congress. Like any investor, you want to buy low in order to sell high in the future. Your agents can get you the best price by insisting on sound, detailed valuation analysis with oversight and plenty of market checks that compare your deal to those happening in the private sector. It's a very technical process and it's reassuring to have *independent* market experts assist the government.
- **Own What You Bail.** John Paulson, whose hedge fund called the mortgage meltdown correctly, has pointed to the legendary Warren Buffett as a model for taxpayers. Mr. Buffett invested \$5 billion in Goldman Sachs, receiving "perpetual" preferred shares in the firm (quasi-debt with an attractive 10% interest rate). But he also got warrants to buy approximately \$5 billion of common stock at a discounted price of \$115 per share. Like Mr. Buffett, you don't want just the debt, but also ownership in the banks to enjoy a big financial upside after you've rescued them and they start growing in value. The bill includes warrants and a "make whole" provision where banks compensate you for future losses if it turns out that the price you paid was too high. That's only fair since you are compelled to rescue them at a time when the market cannot price what you are buying. Note to government: GE also announced a Buffett investment of \$3 billion with "perpetual" preferred plus warrants – our clients want what Warren Buffett and other market players are getting.
- **The Good News.** Our financial analysis is that you are positioned to make a profit on your \$700 billion in the years ahead. With good management, the portfolio should be quite valuable and in some scenarios you could reap handsome returns. The keys to getting high returns are a) fair pricing of the assets you purchase b) being an owner in the banks c) and good, active management of your portfolio by the government (and the fund managers they hire to help).
- **Why Do it at All?** We left this issue aside because the bail-out is happening whether we like it or not. But there are two arguments for this deal:
 - 1) On September 29th the Dow plunged 777 points on news that the bailout was floundering in Congress. That erased approximately \$1.2 trillion of market value from the US stock market in just 6 ½ hours of trading -- \$1.2 trillion of *your* 401Ks, retirement accounts, etc. You have a big and direct stake and as we continue to see, things can get a lot worse very quickly.
 - 2) By setting a price floor on mortgage assets held by **all** financial institutions, the bail-out will allow them to get back to issuing new credit and trading existing debt. The financial "circulatory system" will restart, pumping capital from savers and investors into loans and other investments for homes, cars, educations, building plants, opening new offices and hiring more employees. Your indirect stakes are real, immediate and systemic.

Stripped of rhetoric, the argument is that taxpayers like you have a huge direct and indirect stake in a functioning financial system and the cost of letting financial institutions sink or swim will likely be greater than bailing them out

now, perhaps much greater. As financial professionals who do no business in mortgage credit markets, and as fellow taxpayers, we agree with that risk analysis.

- **What's Ahead.** Obviously, this deal is no panacea. We've seen that stock markets will not soar and the economy will not take off any time soon. Washington Mutual, once worth over \$60 billion, approached zero just before the Feds stepped in and we can expect some weaker US banks to go under or be acquired at knock down prices. Like Belgium's Fortis, some European and Asian banks will be "nationalized" or bailed-out. So, yes, expect to see an end to the market free-fall, rampant uncertainty, credit illiquidity and the most dire "doomsday" economic scenarios. But hang on for more scary times ahead.
- **Watch the Swinging Pendulum.** We also advise you to take note that the balance of power is tipping from financial markets to the government. So whether it's Senator Obama or Senator McCain, our next president will likely preside over increased government regulation that will transform the financial services sector and their regulatory agencies. On that we will simply say that the history of government regulation of financial markets is one of decidedly mixed results. Eventually, you should do fine in the bail-out transaction but be careful of what else you're being sold or what you ask for in this environment.

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