



## The Fall of Lehman: How To Fix It - Part II

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History has a funny way of humbling men. So do markets. Perhaps the most disturbing aspect of Lehman Brothers' fall is that it comes almost seven years to the day after 9-11. That day was supposed to teach us humility, and the fall of Lehman, coming six months after the collapse of Bear Stearns and coupled with Merrill Lynch's disappearance as an independent company, are the result of a complete lack of humility on the part of those executives charged with leading the world's most important purveyors of capital in the post-9-11 world. For all the talk of pulling together in the wake of the terrorist attacks that shook America to the core and that supposedly set our priorities straight, Wall Street rushed headlong back to its mindless pursuit of profits and speculation without consideration for the consequences of its actions. Now the chickens have come home to roost.

In April 2008, *HCM* published a controversial essay entitled "How To Fix It," in which we outlined our (unsolicited) recommendations for how to correct the excesses that led to the credit crisis that began in mid-2007 and brought us to this historic day. We are republishing that issue of the market letter by attachment for those who did not read it the first time. Our key recommendations, which seemed much more radical in April than they do today, were the following:

- Improve financial industry regulation and replace substance over form in the regulation we have.
- Place absolute leverage limitations on financial institutions at much lower levels than the 30:1 levels that led to this crisis.
- Place an absolute limitation on hedge fund leverage.
- Regulate Wall Street compensation by basing it on multiple years' performance, add clawbacks and high water marks, and limit cash compensation that is paid out and weakens these firms' balance sheets.
- Tax private equity firms' carried interests at ordinary interest rates rather than capital gains rates and restrict private equity firms' ability to go public.
- Outlaw off-balance sheet entities.
- Reinststitute the uptick rule with respect to short selling.

Finally, we made the point that too much economic activity in the United States was aimed at speculation rather than production. For example, the equity markets are increasingly dominated by quantitative investment strategies that are



driven by considerations that are totally divorced from considerations of fundamental value. At the same time, the credit markets are increasingly utilized to finance change-of-control transactions for private equity firms that are done simply because low cost financing is available, not because a project is going to add to the productive capacity or capital account of the nation. As we wrote in that April issue, "[a]t some point, society has to figure out that the way an investor earns his money is even more important than the amount of money he makes. This is why human beings were vested with moral sentiments, so they could distinguish the quality of human conduct from the quantity of its results."

These changes cannot and will not be effected simply by legislative fiat. It is incumbent upon the gatekeepers of capital - the fiduciaries that make the decisions about allocating capital - to bring discipline to the system. This will require a rethinking of their priorities and a willingness to add to their investment calculus considerations that exceed their own narrow interests about short-term investment returns. Our system requires a new concept of fiduciary duty that encompasses systemic as well as single-firm interests, and that focuses to a greater degree on risk-adjusted returns than raw numerical returns. Obviously the forces that led to this weekend's events have been building for many years, and the changes needed to fix the system will not be made overnight. But we should not let this occasion pass to reflect on what has occurred.

### **Imagine You Are On the Deck of The Titanic (Because You Are)**

It is clear to us that the Federal Reserve and United States Treasury are not underestimating the enormity of the crisis. Continuing to write checks to bail out the private sector would have been the wrong decision, but the fallout is going to be severe. The next domino to fall may be the insurance giant, American International Group, Inc. (AIG), which is facing credit rating downgrades that will force it to post more collateral (that it doesn't have )on a large volume of credit insurance contracts. AIG is a much larger systemic threat than Lehman Brothers ever was, so this situation is profoundly serious. In *HCM's* judgment, investors should not try to pick a bottom in today's or this week's market. The market is going to experience extraordinary volatility today and over the immediate future. Play the market at your own risk and only with money you can afford to lose. The indices are heading significantly lower, as we have previously forecast. Gold, short-term U.S. Treasuries, short-term Swiss and German government paper, the Swiss franc, and certain Asian currencies like the Singapore dollar are the safest places to park your cash for the moment. The U.S. dollar continues to be debased (less against the Euro, which remains compromised, than against Asian currencies and the Swiss franc), particularly by the startling and historic decision by the Federal Reserve to accept equity securities at its discount window. If nothing else, that decision alone suggests the enormity and depth of the crisis we are facing. We never thought we'd live to see the day that the American central



bank would accept equity as collateral for loans. We have to admit that took us by surprise and made us very nervous.

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