

## Why Wall Street Won't be Reformed

By Robert Huebscher

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*Michael E. Lewitt, who co-founded Florida-based Harch Capital in 1991, authors The HCM Market Letter, a monthly review of the financial markets and political world that he began writing in January 2000. Since then, the publication has gained a large following in financial, political and academic circles for its outspoken views on financial markets, market regulation, politics and culture. You can subscribe to the HCM Market Letter [here](#) and read the latest issue [here](#).*

*In his recently released book The Death of Capital (available from the link at right), he looks at how the U.S. economy has increasingly been dominated by short-term speculation rather than industrial expansion in recent years. That disastrous trend, described here as financialization, ignores the fact that capital itself is a highly unstable process rather than a fixed object or category. As a result of our failure to understand the true nature of capital, we have developed a financial and regulatory system that does exactly the opposite of what it should be doing – it favors obscurity over transparency and foments instability rather than growth.*

*We interviewed Mr. Lewitt on June 3.*



**The title of your book is *The Death of Capital*, and you have a somewhat unconventional definition of “capital” – you define it as a process, not a structure or a category. Can you discuss your definition of capital and how it died in 2008?**

Capital stopped moving and really froze in place in the fall of 2008. This owed to the combination of years and years of bad fiscal and monetary policies and also flawed thinking about investing and about the actual nature of capital.

Markets have been constructed on two premises that are completely wrong. One is that markets are efficient, and the other is that investors are rational.

At the same time there is also a misapprehension of the definition of capital. Capital is really a chameleon-like process where economic value is embodied in different forms. What capital is really doing is reflecting or representing the underlying human relationships that create economic value. It's very unstable. And, unfortunately, it is not regulated or managed with that in mind. As a result, it



continually is threatened with what I call "death." It's continually destroyed by both policymakers and investors. That's what I try to get out in the book.

**One of the long-term trends that you cite as contributing to that death is "financialization." Can you talk about what that is, and what has been its impact on our economy and on our culture?**

I just read a very interesting research piece that talked about financial litigation. It talks about something that other historians and cultural critics have discussed, and which I discuss in the book. It is the whole idea that financialization has represented the later stages of an economic cycle. Financialization is the point in time at which manufacturing and industrial production give way to the dominance of finance. You see it in various ways. You see it in the percentage of S&P profits that come from the financial industry. You see it in terms of how capital is directed not into activities that enhance the productive capacity of the economy but more into speculative activities that are basically the trading of money back and forth in various different forms.

Financialization is something that is facilitated in large part by computers and the technology that allowed all kinds of financial instruments to be digitized. Every financial instrument can be reduced to ones and zeros, which not only made them much more tradable but also sort of eradicated the differences between stocks, bonds, and derivatives, and right now they are all really interchangeable. The result has been that increasing amounts of the economy are directed to nonproductive uses, meaning uses that do not add to the productive capacity of the economy, that do not create jobs in the industrial sector, do not finance R&D, do not finance the building of facilities and so on.

It tends to be a late-stage historical phenomenon. That's one of the things that we all need to think a lot about. People say, "Well, the US doesn't manufacture anything anymore." That's really an expression of financialization. Other economies where there is manufacturing are in a much earlier phase of their economic development. We are in a late phase. The problem is, where do we go from here? We keep pouring more and more of our intellectual and financial resources into unproductive activities that are not helping us solve our economic problems or meet our economic needs.

Our energy policy is flawed. Our financial reform policy is flawed. Our industrial policy is flawed. We don't have tax breaks that are aimed at giving the right kind of incentives to create economic value or at favoring certain kinds of activities that would be productive. It's all part of a large package. It's very closely tied. Eisenhower talked about the military-industrial complex. Now we have the political-financial complex, and it has taken over. The financial industry exerts enormous political power, and that is part of financialization as well.



**One of the unproductive aspects of our economy now, which you talked about, and which I think you say is also fueling speculation, is the private equity industry. How has private equity been corrupted over the last 30-40 years, and what problems has it created for our economy in a broader sense?**

My involvement with private equity goes back now more than 20 years to when I was at Drexel Burnham. After that firm collapsed, my firm was hired to manage the direct employee partnerships, which was a big portfolio of private equity. At that point a lot of those deals were done to take businesses out of large conglomerates, for example Beatrice Foods, and to really improve the efficiency and productivity of corporations.

Of course, there were some early deals that were very successful, like Gibson Greetings that William Simon did at Wesray. That just attracted tons of capital to private equity. As with all good ideas on Wall Street, capital crowded into the business. Too much money was chasing too few opportunities. The so-called management innovations that were used to improve productivity in the early days, meaning the late 1970s and early 1980s, when KKR started, gave way to a lot of mediocrity. A lot of activity really just involved substituting debt for equity on balance sheets. This process has just continued to proceed.

The signs of it are things like private equity companies selling portfolio companies to each other, or flipping them back and forth, and dividend deals where a company has a lot of debt. It will pay down a little debt, and then the LBO sponsor will dividend money out. These companies in general have way too much leverage in them. As a result, it really does impair their competitiveness. It takes money that clearly could be used for R&D, jobs, or plant construction, and it's used to pay bankers, pay interest and principal on debt.

There are all kinds of studies that the private equity industry has paid for that try to say that private equity creates jobs, that it creates better returns, and so on. The evidence is not there. The ironic thing is if you look at the returns, and you compare them to investing say in public equity with even smaller amounts of leverage than you would have in private equity, you would see that the returns in public equity are much better.

Furthermore, if you adjust private equity returns for leverage, concentration risk (these are not widely diversified portfolios), illiquidity, and for fees, you can see that these are vehicles that serve the managers not the investors. The result has really contributed to what I consider to be the over-leveraging of corporate America. To me, it is a very dangerous long-term proposition, because these companies have to devote their capital to repaying debt rather than to growing.



**Let's talk about financial reform, which you address throughout your book, and in particular in Chapter 8, "Finance after Armageddon." Michael Lewis had an entertaining article in the *New York's Times* Sunday, [Shorting Reform](#). One of the points he made is that the focus on preventing taxpayer money from being used for future bailouts of financial institutions is misguided, and it suppresses debate on more important issues. I'm wondering what your thoughts are on that?**

The financial reform plan ultimately does very little to prevent the kind of conditions that will lead to more booms and busts. There have been some constructive changes. The leverage in these large institutions is or will be much lower. Their pay practices have to some extent been remediated.

But the financial reform bill misses the biggest factor in financial market crises right now, which is the "contagion" factor. The contagion is created by the interconnected nature of financial institutions. How are they interconnected? They are interconnected by trading with each other. What is the thing they trade with each other the most? It's derivatives, and in many cases it is credit default swaps (CDS).

By not doing enough to limit trading in naked credit default swaps, which are those that are not used to hedge underlying positions, the whole financial reform package really misses the boat in terms of preventing another crisis, because you have all these firms that are really interconnected. So the question of "too big to fail" is a fallacy. It's not that there's one firm too big to fail; all the firms are linked together into one huge entity that's too big to fail, and it is only as strong as its weakest link.

The current proposals are completely inadequate. Putting CDS on an exchange is what everybody has hung their hat on. That has some attributes that on the surface seem sensible, because you can supposedly track these trades better, and there's supposedly more transparency in trading and pricing. But what's really going to happen is the exchanges themselves are going to be considered worthy of being bailed out. The exchanges are going to have members that are not systemically important that are going to benefit from those bailouts. So the bailout mentality just keeps extending, and extending, and extending.

What they really need to do is ban naked credit defaults swaps, which I know is considered radical by people on Wall Street. But the fact is 95% of credit default swaps are done for speculation. They are not done to hedge existing positions. And they create a systemic risk that is extremely potent. In addition, the nature of credit default swaps is such that they create an incentive to see firms default, because that's how you create the payout on the CDS. It creates a very perverse incentive in the financial system to see firms fail and that is also very dangerous.



The financial reform bill fails in that respect.

### **Will the Volcker rule help?**

The Volcker rule misses the boat because it does not recognize the fact that so much capital is not in the banking system. It is in hedge funds and other non-banks. It doesn't really address that at all. I agree completely that banks should not be speculating with depositor's money. That's a good thing, but it is not a panacea. It really misses again, since a lot of speculation is done outside the banks.

We'll see how far they get on dark pools, program trading, and computer trading. As we saw on May 6 [the date of the "flash crash"], that's a very dangerous kind of activity, especially when it's done in dark pools where there is no transparency. It just seems completely inimical to what you'd want to see in a system that should be favoring transparency.

**In terms of systemic risk, one of the things that you've called for is a single independent regulatory body to monitor and regulate it. A couple of weeks ago, we covered a talk by a hedge fund manager Seth Klarman, and he said that such a body or person would be ineffective, because it is unlikely that they would be able to take necessary but unpopular actions at times when the economy and the markets are functioning strongly, and then be able to defend those actions against potential congressional inquiry. How you would respond to those concerns, and why you do feel it's important to have that regulator?**

He makes a very valid point that is true of all these regulators. The fact is we've suffered from abject regulatory failure for years.

The reason I believe we need the unified regulators is very simple. The financial markets have figured out how to deconstruct all financial instruments into the same basic building blocks, ones and zeros. That is something Goldman Sachs figured out, by the way, ahead of most people, and that is why they have been so successful. As a result, to have different regulators for different types of activities really is not reflective of the underlying realities of markets today. Furthermore, we've seen the gaps in regulators that have led to huge problems in terms of covering activities, failing to uncover frauds, and so on.

What I am suggesting is we have a unified regulator that, underneath it, has all of the different sub-regulators, but that there is a single authority. It should not be the Fed, because the Fed has shown itself to be extremely pro-cyclical in its practices, but some kind of independent body that can make those very tough calls. And I think Seth is right. It's going to be a tough — it's tough to do the right thing and to go against the political powers in this country. That's one of the symptoms of financialization. The political power is vested with the large banks and large



financial institutions. This is leading us down a very dangerous road, and we need a different approach, because this approach is just not working.

We need a much more powerful kind of regulator that can step forward, and not be beholden to any special interest. That's extremely idealistic and it's probably unrealistic, but we have to strive for that, because what we have right now is not doing anything.

The so-called bipartisan financial inquiry, led by Phil Angelides, is pathetic. They sit there and they pretend to ask difficult questions, but it is a complete mockery of everybody and anybody who cares about the system to think that that is going to do anything.

**Let's turn to the rating agencies, which continue to function without any change to their "issuer-pays" business model. Most sophisticated investors no longer rely on their ratings.**

We certainly don't.

**Is there any way that the process can be reformed so that ratings would actually be meaningful and useful?**

The problem is the system suffers from what we call "path dependency," where it is so deeply embedded that it is very hard to dislodge. There are some practical things you can do and then it's going to take a while to see it work. First of all, take away the mandate that investments have to be guided, or have to conform to these ratings. Second, open up the field to more competition. Right now these guys have a congressionally granted monopoly. They have abused it, and it just doesn't work.

Is there really a chance it will be changed? It doesn't look like it. We'll see what Barney Frank and folks come up with. Look, there is a huge opportunity, in my view if you can evaluate these things to sell research to institutions. Institutions are so afraid of their own shadow, because of the whole construct we have about fiduciary duty – which I write about in the book – which I think is flawed.

Big institutions – say, pension funds – will not give money to a manager until they have all these consultants approve them. There's this whole superstructure of "cover your butt" that is a big part of it. Ratings were done as an excuse to not think, and not look "under the hood," and to just assume that it was okay.

Reform will be somewhat incremental, but it just amazes me, for example, when Moody's downgraded Spain or downgraded any company, that markets react. These rating agencies have been completely discredited intellectually and ethically, and yet the markets still react to them in part because they have to. They are



required. So the most important thing is to get rid of the legislative requirement, and then move from there, and hope that more people will use independent judgment.

In our mandates for institutions, we don't pay any attention to what the rating agencies say. We make our own judgments, because the agencies are notoriously incorrect.

**You have been generally very pessimistic about the likelihood that our political system, Congress, and the President will take the necessary actions toward effective reform. Are there any recent developments that either have raised or decreased your level of optimism?**

The carried interest tax debate has been very depressing. This area should have been reformed a long time ago.

**This is the tax on private equity and venture capital?**

Yes. Their profits are taxed as capital gains, not as ordinary income. Of course that gap is closing, but still it's been depressing, because it's really unfortunate to see how hard the private equity firms have lobbied to preserve something that is clearly not justified intellectually. It's not justified in terms of any of the principles of our tax law. Carried interest is the product of labor. This is a tax on labor, not a tax on capital. There's just no policy justification for giving these firms, particularly private equity firms, favored treatment.

There may well be a policy justification for giving venture capital investors favored treatment, because venture capital creates jobs, creates new businesses and so on. But private equity, as I described earlier, does not. But for Steve Schwarzman and Henry Kravis to go to Congress and say "oh, we're going to stop innovating and we're going to stop taking risks" if we get this tax is complete malarkey.

First of all, they don't innovate. Second, what risks are they taking? They are getting 2% fees on billions of dollars. They don't have to do anything and they are enriching themselves. In a time of financial crisis, it's disgraceful to see the richest Americans lobby on an intellectually fraudulent basis for this kind of tax break.

The House has again passed a bill – they've done this before – that will tax these investments as capital gains with some slight adjustment or compromise to make it a little was painful. The Senate Finance Committee has not gone along with this before and it's just disgraceful. This has created an American oligarchy that is contrary to any notion of fairness. These individuals make millions of dollars, and they should not pay a lower tax rate than the people who clean their offices, drive them around, and teach their children. It's just morally wrong.



This isn't going to raise a lot of revenue. That's not the point. The point is, people need to believe the system is fair to buy into it, and to participate, and to want to help fix it. This has the opposite result.

**One of the things you say is that the actions the government took in 2008 are certain to have long-term destabilizing effects on the global economy. What are some of those effects that concern you the most, and how do you position your own portfolios, the ones you manage to defend and hedge against those risks? What would you say are the key take-aways from an investor's standpoint from your book?**

Our policies have created a sense of moral hazard that is just very dangerous because of the bailouts. You can say that bailouts are necessary, unnecessary, whatever. The fact is that there is just a belief that the government will come in, and step in and bail people out. I think that's a very dangerous idea.

A lot of the ways they did it, for example, with the AIG payments to counterparties, were unnecessary. They could have simply put a blanket government guarantee on AIG's obligations and let these contracts run off in trade. It was a mistake.

The first issue is moral hazard and the second thing is the sheer amount, the trillions of dollars of additional debt that had to be incurred to make up for the losses that institutions suffered as a result of their mistakes.

Too little has been done in terms of accountability. Not legal accountability; that's a separate issue. The government has been too quick to criminalize things that shouldn't be crimes. Yesterday, Ray McDaniel, who's the head of Moody's, testified for the Financial Reform Committee. He was asked a question that actually made sense: "Why are you still here? You should have been fired. You are the head of this company, Moody's, and you gave bad ratings that were just completely flawed. Why do you still have a job?"

It's completely inexcusable. It's like when Franklin Raines walked away with \$100 million or so after running Fannie Mae and committing accounting fraud. Nothing happened. We need more accountability where it counts, and less politicized "show trial" accountability.

The other thing still in place is the pro-cyclicality of monetary policy. That's something that keeps us stuck in a boom-and-bust cycle. We invest based on the belief that cycle is firmly in place, that there's too much debt at all levels of the economy and that the financial system is prone to crises. That's because of the things I discussed earlier, and in large part because of the interconnected nature of all the institutions through their CDS and other trading.



We use a strategy that allows us to go both long and short on credit. We also try to make sure we stay at the top of the capital structure where we are certain that the recovery of our capital is assured if things go south. We avoid investing in lots of the kinds of activities that I've been critical of. We are not going to buy a bond issued in a deal to pay a dividend to a private equity company. We're not going to invest in a company that's been sold from one private equity firm to another. What we are looking to do is invest in productive businesses and areas in the economy that are less involved with financialization, for lack of a better word.

We assume that there will be another crisis and another significant sell-off in the markets, so we try to buy the instruments that will not suffer any permanent principal loss and also will be less volatile in those kinds of environments. They do exist, but it's a small portion of the less-than-investment-grade market. That's one reason why we don't grow our assets endlessly. You can't outrun the market. You need to be able to avoid being stuck in the boom-and-bust cycle, because it is firmly embedded, and it is not going to change any time soon.

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