Part One

INSTRUMENTS OF CHANGE

Chapter 1

Sea of Liquidity

Can you have too much money, so much that you spend it unwisely? Can having less money give you a competitive advantage over those with more?

I think the answer to these questions is "definitely yes." And before you tell me that I'm crazy, I'll explain. No, I'm not turning in my Wall Street name tag just yet and taking a vow of poverty.

It's just that money, in the form of the sell side's balance sheet and liquidity, can make the sell side act in ways that are open to debate.

One of the strengths of the sell side has been its lofty liquidity position, specifically its access to capital. That's why the buy side has made many withdrawals from the sell side's ATM since traders and speculators first negotiated a truce they called the Buttonwood Agreement, which laid the groundwork for the New York Stock Exchange.

The sell side readily financed the needs of the buy side because it enjoyed the transaction fees it was getting in return. What it didn't fully realize was that it was supercharging the buy side's growth by providing it with the deadliest weapon—liquidity. With liquidity as their ammunition, hedge funds and private equity funds became formidable competitors.

It was as though the sell side was providing weapons to the buy side, which the buy side used to its advantage to propel its growth. It was a battle the sell side didn't quite realize it was entering. Today, it's too late for the sell side to do anything about it—except play its own hand while emulating its progeny.

I saw the sell side from a front-row seat, and a question pops up. Did it act downright "liquidity silly" during the rise of the buy side? If you want to understand the Battle for Wall Street, liquidity is a good place to start.

Overplaying Your Ammunition

The summer of 2000 was filled with news about the presidential election as well as some heavy-hitting stories about sell-side firms merging with each other: UBS merged with Paine Webber;[1] JPMorgan merged with Chase;[2] and AXA Financial sold its majority stake in Donaldson, Lufkin & Jenrette (DLJ) to Credit Suisse.[3] These skirmishes within the larger Battle for Wall Street demonstrated sell-siders duking it out amongst themselves.

These deals filled not only the airwaves, but also the hallways of my old firm. We were involved particularly with AXA, which sold its majority stake in DLJ to Credit Suisse—a timely move, by my calculation.[4] By divesting itself of DLJ (which was a major sell-side player), AXA got out of one meaningful sell-side business just as the buy side was starting its ascendancy. It wisely decided to shift its focus toward the buy side.

A few months after AXA sold DLJ, it acquired Sanford Bernstein, a major money management firm, which it subsequently combined with its existing Alliance Capital Management.[5] Today, Alliance Bernstein is a major player in the buy-side business of money management.

Looking back at the Credit Suisse/DLJ transaction today, it paid about $13.7 billion for . . . what?[6]

That transaction—any transaction—is debatable. On one hand, Credit Suisse acquired a number of quality businesses. Three come to mind: a leverage finance business (funding companies with a greater-than-normal debt-to-equity ratio)[7]; a high-yield bond business (offering bonds rated below investment grade)[8]; and a merchant bank (providing investment bank services to multinational corporations).[9]

On the other hand, a good deal of what is bought on Wall Street is talent: the human capital at the firms being acquired. Yet, some of the talent Credit Suisse set out to acquire—the people who were part of the DLJ franchise—left after the merger.

And where did they go? A healthy number went to the buy side. After all, the size of a combined organization like Credit Suisse/DLJ may not have been a selling point. Two primary benefits offered by a big organization like Credit Suisse—technology and liquidity—were becoming more available to the buy side just as Credit Suisse was plunking down its billions.

Whereas the AXA buy-side expansion in the early 2000s was timely, the Credit Suisse/DLJ timing in 2000 may have been off from both a technology and a liquidity angle.

Technology was becoming less expensive and more powerful, and the information that could be gleaned from it was better and broader. One of the edges that investment bankers had—information—was being eroded by the technology, which made that information much more readily accessible. (I'll cover this explosion in technology in the next chapter. Actually, explosion is an understatement—it was more like a line of cannons blasting its way through a crumbling Maginot line.)

And the buy side was building up its liquidity. While the sell side still had an edge, it was quickly being eroded. The folks at the investment banks saw this happening and were heading for the doors. Those investment bankers who stayed home saw that the sell side had more liquidity than it could usefully deploy.

A quote that is often attributed to Wallis Simpson, Duchess of Windsor, says, "You can never be too rich or too thin." I don't know about the thin part, but I believe you can be too rich, and it is possible that the sell side was in this position, to its detriment.

For example, did NationsBank (now Bank of America) and General Electric overplay their balance-sheet and liquidity positions in acquiring sell-side firms? NationsBank bought Montgomery Securities,[10] while General Electric bought Kidder Peabody.[11] Today, both sell-side firms are history.

Let's look at the sell side's misusing its liquidity to win business. When giving advice on mergers and acquisitions or capital markets, a number of firms tend to give away liquidity as well. They do this by telling a prospective customer that, if hired to manage a deal, they will provide more attractive funding as well.

The buy side, however, doesn't get involved with those types of deals. It doesn't finance its customers, and can be smarter with decisions regarding its use of capital. As such, it can avoid this liquidity trap.

Bottom Line

In the liquidity race, the sell side should be a step ahead of the buy side, but recently it does not seem to be using this benefit to its advantage. When it stretches the liquidity band and/or the balance-sheet band, and tries to overreach for, say, market share or earnings, either band can snap back. When it does, the sell side stumbles; it falls a step behind the buy side.

I call that a fall from grace.

The King

There is an aphorism in the business world that has become so widely used that it's now a cliché: "Cash is king."

While this phrase may sound trite, no one I know on Wall Street disputes its accuracy or relevance. Cash, or should I say capital, is the lifeblood of every business. A company's growth, even survival, depends on it. This is one of the primary reasons that the sell side was the king of the financial world for so many years: It provided corporations with windows on capital or—to use the more technical term—*liquidity.*

Companies are always keen for fresh capital to increase their profits and, ultimately, their valuation—whether it's their stock price (if they're publicly traded) or their franchise value (if they're privately held).

Liquidity

"Liquidity, in the financial sense, is a measure of the ease with which one asset can be traded for another. Land . . . is usually considered the least liquid of investments. Alternatively, cash is the most liquid."

Source: John Steele Gordon, *The Great Game.* New York: Scribner, 1999, p. 186.

For a long time, it was impossible for companies to go directly to investors for capital because investors were often fragmented and scattered. Sell-side bankers justified their fees, in part, by being the ones who could coax money from investors, gather it all in one place, and make it available to corporations. They were like the generals of mercenary armies, able to bring together men and materiel—for a price. These investment banking generals are navigating through a very different battlefield in 2008, which I will cover later in the book.

They could have said, "We have the sales relationships, we know where those with money are located, we know who likes to invest in autos or aerospace or technology or whichever industry you are in, and we alone have the wherewithal to make your deal happen."

The investment bankers of the sell side held the keys to the vault—always a good position to be in. In this vault was access to the public and private markets, as well as the sell side's own capital, which the sell side used to create liquidity that, in turn, was used to hold sway over the buy side.

And these investment bankers had—and have—additional powers at their command. The brains, brawn, and capital to create secondary markets were theirs. They knew, better than anyone else, which investors held which stocks and bonds, and they had relationships with many of them. They understood the markets best, had the skills needed to value companies, and knew how various types of issues were traded. They had the sophistication and institutional structure required to raise money for virtually every type of company, using any type of asset class.

Sounds good, right? Wrong. And we can thank liquidity for that.

In this Battle for Wall Street, liquidity has played a major role. Historically, the sell side was a bridge to investors' capital. But with greater liquidity, the buy side has been able to gather an investor capital base that was unthinkable in the past.

Hedge Fund

"An aggressively managed portfolio of investments that uses advanced investment strategies such as leverage, long, short, and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark)."

Source: Investopedia, www.investopedia.com/terms/h/hedgefund.asp.

For example, a half dozen guys could set up shop in Greenwich, Manhattan, or wherever, pull out their electronic Rolodexes, make some calls to moneyed folk they know, and raise hundreds of millions of dollars or more to start a hedge fund. Not that long ago, such an enterprise would have been impossible.

What was also at one time unthinkable—explosive hedge fund growth—is today a fact. In the last 20 years, the number of hedge funds has grown from 100 to approximately 10,000, and their assets under management have gone from $20 billion to several trillion dollars.[12] That's a lot of hedge funds and a lot of assets; thank you, liquidity.

As an example of how active—and important—hedge funds have become, there was a time when investment bankers, underwriting securities, refused to allocate part of their offerings to hedge funds because these funds were considered to be hot money, "flippers," rather than long-term players. Today, the investment bankers are singing a different tune: one of their first phone calls is to the hedge funds.

Bottom Line

The rise of hedge funds to their current pinnacle of prominence is due, in part, to the expansion of liquidity and the buy side's embrace of it, as well as its ability to use it to its advantage. There's more to liquidity than just the rise of hedge funds.

Long Live the King

Liquidity creates progeny. Collateralized mortgage obligations (CMOs) are an example. Before CMOs, commercial banks typically handled mortgages. Now, mortgages are sliced and diced into tranches (single stages within a series of staged investments) based on different risk and yield levels. This has had the effect of increasing the variety of risks and yields associated with mortgage investing.[13]

These new levels led to an expanded number of investors. More investors means more money, which increases liquidity. We're dealing with circularity here: Liquidity creates new products, and new products create more liquidity.

A second example of liquidity is dark pools. They match buyers and sellers in ways where neither knows the other's identity. This creates liquidity where it previously didn't exist. Investors are more willing to become players when they have the shield of anonymity—and the more players, the more liquidity.

Is the expansion of liquidity seen in the past decade or so likely to continue? Well, liquidity has always waxed and waned to some degree.

During my career, I've seen liquidity go through various cycles. The 1980s had a lot of it, until the stock market crash of October 1987, when liquidity contracted. It recovered, only to be sent into a reversal with the start of the first Gulf War in 1990, when it again went into a restrained mode. It loosened up again, and for the rest of the 1990s, liquidity was quite plentiful. But when the Internet bubble burst in 2000, liquidity went into a contraction phase again, then returned to an expansionary track until the credit meltdown of 2007.

That's one too many liquidity downturns for an old-timer like me.

Dark Pools

"A slang term that refers to the trading volume created from institutional orders, which are unavailable to the public. The bulk of dark pool liquidity is represented by block trades facilitated away from the central exchanges. Also referred to as the 'upstairs market.' The dark pool gets its name because details of these trades are concealed from the public, clouding the transactions like murky water. Some traders that use a strategy based on liquidity feel that dark pool liquidity should be publicized."

Source: Investopedia, www.investopedia.com/terms/d/dark_pool_liquidity.asp.

Bottom Line

The credit crunch of 2007–2008 showed that liquidity can contract dramatically and swiftly. But, because of the factors I've cited above, I have to say that the expansion of liquidity is permanent.

The globalization of the world economy has made it dramatically easier for investors around the world to get in the game. The more participants, the more money floats around, looking for investments to latch onto. This new army of investors is opening the battle to many new fronts.

Case Study: BlackRock—Liquidity as Friend

In 1988, a sell-sider named Larry Fink cofounded a management firm called Blackstone Financial, now called BlackRock. At First Boston (now Credit Suisse), Fink was instrumental in the development of mortgage-backed securities, which were sold to investors. Understanding the value proposition of these securities, he crossed the Street, became a buy-sider, and marketed these securities directly to investors.

Fink also has an eye for human talent, and the BlackRock team that joined him was like the roster of baseball's annual All-Star game—superstars, every one of them.

Back in 1988, where did that All-Star team come from? One place was Fink's former sell-side firm. One of them was Rob Kapito from the mortgage trading desk.[14] When Fink told Kapito he was leaving Credit Suisse (and had not yet asked Kapito to join his team), Kapito reportedly asked, "Where are we going?" That's trust. Also on the team was Barbara Novick[15] from structured products, and Ben Golub,[16] who recognized early the importance of financial technology. One of the keys to BlackRock's success is that, 20 years later as I write this book, all of these stars are still working alongside Fink.

In addition, some members of the original BlackRock team hailed from the sell-side firm Lehman Brothers. (I will discuss a few of those All-Stars later in the book.)

Keep in mind that, when it opened for business in 1988, BlackRock had no assets and no buy-side track record to speak of. Fink and his team went to the sell side to raise investor capital—assets under management—in the form of closed-end funds.

The investment bankers, always hungry for fees, agreed to underwrite a fund for Fink. And then a second fund. And then a third. And more.

Instead of the sell side's salespeople selling, say, IBM to their customers, they sold the BlackRock family of investment

Closed End Fund

"A fund that has a fixed amount of shares outstanding, unlike mutual funds, which are open-ended (allow new shares to be purchased). Closed-end funds behave more like stocks because they trade on an exchange and the price is determined by market demand after an initial public offering process. Closed-end funds can trade below their net asset value or above it."

Source: http://mutualfunds.about.com/od/glossaries/g/closed_end.htm funds. It was a classic case of the buy side's leveraging the sell side's liquidity—access to financial markets—to fuel its growth.

All of this was for one asset class: fixed-income mortgages.[17] Fink and his team understood the product and the technology behind it—but also understood the value of the sell side.

The result? As of December 31, 2007, BlackRock had over $1.3 trillion in assets under management.[18] That's a lot of money by any definition. I would say that BlackRock's success is one of Wall Street's great stories.

Interestingly, the sell side—namely, Merrill Lynch, now owned by Bank of America—sold its disappointing money management business (Merrill Lynch Investment Management) to BlackRock, in return for a 49 percent interest in the combined entity.[19] As I write this, the BlackRock investment is one of the truly bright spots in Merrill's portfolio.

The sell side, Merrill, looking to the buy side, BlackRock, as a partner for investment performance and returns? That's not the Wall Street I joined in the early 1980s.

Case Study: AIG—Liquidity as Foe

Before the credit crunch of 2007–2008, who would have thought the insurance giant AIG would face liquidity issues? Who would have imagined that given its size (market capitalization of $180 billion), AIG would fall under the knife of the mortgage debacle?

But fall they did. They fell into the hands of the U.S. government.

In September 2008, after severe losses and liquidity issues that drove it to the brink of collapse, AIG accepted a federal bailout that would give the company an approximately $85 billion line of credit, and would give the government about an 80 percent equity stake in AIG.[20]

Why did the Federal Reserve (Fed) step up with a lifeline?

Credit Default Swap

"A swap designed to transfer the credit exposure of fixed-income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the creditworthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed-income security to the seller of the swap."

Source: Investopedia, www.investopedia.com/terms/c/creditdefaultswap.asp.

The Fed determined a disorderly failure of AIG could create havoc in the global financial markets. To prevent this chaos and ensure an orderly process, the Fed provided a loan to cover AIG's liquidity needs until the company could sell enough assets to fill its capital hole.

Why was AIG in this precarious capital position?

AIG was a provider of insurance guarantees on risky credit default swaps tied to the mortgage market. As the credit crisis of 2007–2008 intensified, AIG was caught in a liquidity death spiral. Those spiraling actions played out like this: AIG went one way on credit default swaps, and with the subprime crisis raging, the market went the other way. Not a good scenario for AIG.

As the credit crisis intensified, AIG incurred write-downs and losses. As a result, Moody's and Standard & Poor's (S&P) downgraded the company's credit ratings. Those credit reductions triggered collateral calls, and AIG was forced to post more capital.

At this point, counterparties (the other parties to these financial transactions) did not want to take AIG's risk. They wanted capital. AIG did not have the capital and could not get access to capital in time to offset the impairment of their assets. They had a severe liquidity issue.

Over its fateful last two weeks as an independent company, AIG's capital issues grew geometrically. According to an industry observer, during that time, AIG's capital requirements skyrocketed to the tune of tens of billions of dollars.

Why didn't AIG—an insurance company—recognize the probability of blowing up if the rating agencies downgraded them from AAA to A (S&P) and AAA to A2 (Moody's)?

Collateral Call

"Collateral is assets provided to secure an obligation. A more recent development is collateralization arrangements used to secure repo, securities lending, and derivatives transactions.

"Under such arrangement, a party who owes an obligation to another party posts collateral—typically consisting of cash or securities—to secure the obligation. In the event that the party defaults on the obligation, the secured party may seize the collateral. In this context, collateral is sometimes called margin.

"In a typical collateral arrangement, the secured obligation is periodically marked-to-market, and the collateral is adjusted to reflect changes in value."

Source: www.riskglossary.com/link/collateral.htm.

I would suspect the answer is that they predicted the probability of a credit downgrade was a low event. But why take even a minimal chance, knowing that it could lead to catastrophic risk?

That risk took their stock down from dinner for two ($70 a share) to less than a Manhattan subway token ($1.50 a share).

The AIG story is rife with ironies. First, the company turned to the Fed after unsuccessful negotiations with the one and only Warren Buffett of Berkshire Hathaway[21]—the same Warren Buffett who invested in Goldman Sachs and General Electric at the height of the credit crisis of 2007–2008. As I write this book, Buffett may still be interested in "in acquiring a couple of AIG's assets depending on what the company was willing to sell."[22]

The second irony is that has been reported that the former AIG chief executive, Maurice Greenberg, would like the chance to bid on the assets that are going to be sold as AIG repays its multibillion-dollar bailout loan from the federal government.[23]

The third irony is that going into the credit crisis, AIG was the world's largest insurer. The AIG left standing at the end of the credit crisis will not be the same—it will be significantly smaller.

AIG—and for that matter, any financial institution falling on the battlefield during the credit crisis—is victim to the bullet called liquidity.

Implications

As I write this, a debate is going on over liquidity. Financing of commercial deals has pretty much come to a stop. Commercial lending has shriveled up. So is the credit crisis due to a lack of liquidity or because the credit window has virtually closed for the time being? This makes for an interesting debate in financial war rooms.

I would suggest it is because the credit window has closed for the time being. To illustrate my point, look no further than at a number of sell-side players, who in early 2008 had aggregate balance-sheet write-downs of approximately $85 billion.[24] Yet, in less than six months, virtually all of it had been replaced by raising new capital. Before the growth in liquidity, making up that sort of loss would have taken years. In the early stages of the subprime crisis, it could be done in a matter of months. In battle terms, this was a definite win for the sell-side team.

Most of the money came from players who, in the last half of the 2000s, became large enough to make a difference—sovereign wealth funds (foreign-owned investment entities). In the first part of 2008, we saw how much liquidity was available and how readily financial firms could get their hands on it. That much liquidity—and that kind of access to it—was new.

Shutting down the credit window, for the most part, has led to shocks within the system. Management and shareholders alike have to ask if the best and brightest on Wall Street really know what they're doing. Do they understand the instruments they've created? Do they have proper management systems in place? Do they understand the risks involved?

As we know, history repeats itself. We've had liquidity and credit crises before. In the 1980s, Japanese banks went crazy buying things, while the Nikkei average dropped about 65 percent during the 1990s, as a result.[25] Too much liquidity led to silly decisions, which led to a major fall. Sound familiar? Who would have imagined that too much liquidity could be your enemy?

What are the lessons to be learned here? Well, we're playing with more risk, which is good as long as we truly understand that risk.

What may not be as good (and here, history repeats itself yet again) is that Wall Street may once again overplay its liquidity hand when the devastating credit crisis of 2007–2008 is only a memory. "Why not?" it asks itself. "Meaningful pools of liquidity are out there in the form of petrodollars and sovereign wealth funds."

Vegas is known to give its high rollers, or "whales," a few extra chips to play with. Do the whales take the new liquidity to the checkout window? Not really. Do the whales overplay their bets? Most likely. The whales on the sell side could well behave the same way—focusing on the next set of gambles rather than future safety.

If history repeats itself, the pain will be worse than it is today—which is even worse than it was during the credit crunch of the early 1990s. That's because we will be playing with ever more liquidity. As the dollar figures become increasingly astronomical, the stakes get higher, and the losses are harder to bear.

If this scenario of repeating crises plays out, and the sell side continues to overplay its balance-sheet hand and toss liquidity around like popcorn, I see the Battle for Wall Street leaning more and more in favor of the buy side.

The buy side has time on its side. It can sit back and wait for opportunities, and can commit capital when it wants, not when the market wants. The buy side, for the most part, is also not tied to the timing of—or held captive to—public earnings. And, finally, the buy side provides capital to itself, in a sense, while the sell side provides capital to its clients.

This entire scenario will not just favor the buy side, but could further widen the gap between the two sides—which could lead to any number of sell-side firms disappearing. Bear Stearns or Lehman Brothers, anyone?

Battle Victorious: **Buy side.**