PART One

The Investing Environment

The first section of this book paints the picture of the recent market environment. Similar to a screenplay, the characters and players are introduced. Once the stage is set, I will walk you through the various scenes that have captured investors' attention and, at times, have created numerous headaches for fixed income portfolio managers.

It is fair to say that the challenges asset managers face have changed over the past decade. Although there were some previously seen headwinds, the time period from 2005 through 2011 brought on numerous conflicts that investors could not have imagined.

I will take you along a journey highlighting the necessity to remain on top of the ongoing changes and evolve with the market. Although the market is not a living and breathing entity, more times than not, it gives the appearance that it is. This is felt by those participants who are engaged in its daily activities, who ride the ups, downs, highs, and lows in an attempt to outpace its returns.

CHAPTER 1

Expect the Unexpected

To succeed, you will soon learn, as I did, the importance of a solid foundation in the basics of education—literacy, both verbal and numerical, and communication skills.

—Alan Greenspan

It's 5:30 A.M. on Monday, September 15. The year is 2008. I am already on my third cup of coffee and riding on—at most—about eight hours of sleep since Friday. I'd spent the weekend glued to the television, watching the story unfold while strategizing my next move. I remember the day as if it were yesterday, sitting in the office, at my desk, staring at my four computer screens and TV, watching the headlines scroll by stating that Lehman Brothers had filed for bankruptcy. The stock was worthless; the company's senior debt was now trading near 27 cents on the dollar with its sub debt in the high teens. As the situation unfolded, the million dollar question that nobody knew how to answer was: How would the markets handle the news and subsequent headlines about Lehman's bankruptcy as they surfaced? Not only was I concerned about how the U.S. and global markets would handle the news, but also, how would the U.S. government, the Fed, and central banks around the world react? What would the repercussions be when the equity markets opened for trading in a few short hours? This was unthinkable. I asked myself, "How could this have happened?"

This should have unfolded differently. The government was expected to step in at some point and throw Lehman a lifeline, as it did when Bear Stearns had fallen into trouble six months prior and needed help. The government played matchmaker, assisting JPMorgan with the purchase of Bear Stearns. The Lehman events that transpired did not follow the "Bear Stearns model;" unfortunately, that model was the simple notion of investors and the media's

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hopes and dreams that clung tightly to government intervention. The dream did not come true.

THE MODEL HAS CHANGED

How could one of the top five investment banks just shut its doors? And not only shut its doors, but do so at an amazing speed. As reality set in over the subsequent trading days, it was becoming clear that the investment bank model had changed—and so had Wall Street. I had always viewed Lehman Brothers as one of the top five pure investment banks. Goldman Sachs, Merrill Lynch, Bear Stearns (before they fell and were purchased by JPMorgan), and JPMorgan rounded out the group. This list was quickly reduced to two. First, through the fire sale purchase of Bear Stearns by JPMorgan, and then, with the bankruptcy of Lehman Brothers, the reductions commenced. Shortly thereafter, Merrill Lynch struck a deal to be purchased by Bank of America, impacting the investment community once again. In the end, out of the original five, only two remain stand-alone entities with some sort of resemblance to pure investment banks.

From a technical perspective, the true investment bank breed is no longer. It is extinct. Why didn't the government attempt to save this company as it did with Bear Stearns? Didn't the government know or realize the implications? That question can be answered with ease. It is a simple no!

The investment banks that were left standing eventually converted to banking institutions. There was one simple reason for the conversion: The transformation provided them the ability to receive cash injections if needed. This is vital to many financial institutions in order to help fulfill the overnight funding requirements. Overnight funding is essential for financial institutions—in particular, investment banks—to support ongoing daily business. The catch in making this transformation—and there always is a catch—is that the lifelines or cash injections to help bolster the company's ailing balance sheet are from the government. Therefore, the government will, to some degree, have its hand in the business. If nothing else, its presence will be felt through added regulation. The invisible hand of the government has just become more visible.

LESSONS LEARNED

There were numerous lessons learned over the course of time, including the prior example of how quickly a company may shift from a going concern

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to going out of business. What differentiates top asset managers from the herd is that they learn from the lessons while the others do not. This holds very true within the world of investing. As far back as there are documented records, there are situations and examples providing lessons to learn. Don't worry; you don't have to dust off the history books or travel back that far to gain insight and for examples to surface.

To start, go back a decade or two and look at the bursting of the technology bubble. It provided some straightforward lessons. At one point in your life, someone (possibly your parents) told you, "Don't put all your eggs in one basket." Sound familiar? If you translate that statement into financial jargon, it would read, "You had better diversify your portfolio to reduce risks." This advice could potentially have saved portfolios—from pension funds to college savings accounts—millions upon millions of dollars, helping to mitigate losses when the markets turned south.

Since the bursting of the technology bubble, investors have navigated through unthinkable events such as terrorist attacks, corporate corruption, and mismanagement at various companies such as Enron, WorldCom, and even Freddie Mac. All these events impact markets, the investor psyche, and ultimately, the way individuals invest. We have also witnessed and lived through a recession in 2004, tied with a jobless recovery and what many call a near miss on a depression-type event with the popping of the mortgage market and structured securities sector a few short years later. This depression-like event changed the investment banking system and the Wall Street landscape forever.

The collapse of Bear Stearns and Lehman Brothers will never be forgotten. I have close friends and colleagues whose hard-earned life savings (in the form of company stock) were washed away in seconds. They were instantly unemployed in one of worst financial job markets in history. In one weekend, Bear Stearns went from a thriving company to just a memory and an asset on JPMorgan's books.

The crisis didn't affect only Wall Street and the individuals employed and living in the financial capital of the world. The crisis also hit Main Street and investors located all over the world; lifelong veterans and those who were right out of business school. The chain of events impacted everyone. This was reality, and it was overlooked by the media and government when headlines were written. This was just the beginning.

FROM BAD TO WORSE

It went from bad to worse. The day following Lehman Brothers' downfall, the Reserve Fund, the first money market fund created, notified investors that

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it had to close its doors, due primarily to its exposure to Lehman Brothers and securities it held within the financial sector. The fund's portfolio no longer traded "at the buck"—money market lingo meaning that each share was not worth one dollar anymore. The buck is the one trait a money market fund lives and, in this case, dies by.

The premise of a money market fund is that an investor deposits one dollar and at any time he or she is able to take a dollar out. Investments in a money market fund, prior to the closing of the Reserve Fund, were always revered as safe. In some instances, investors viewed money market funds as the next safest investment to a bank account. In any event, the shares of the Reserve Fund were worth less than the prior day's value due to losses from the collapse of the financial markets—usually a characteristic of a much riskier investment.

Most investors, if not all, want to forget exactly what happened, but it will take years, if not generations, for that to happen. With what seemed like crisis after crisis, economic and otherwise, the markets felt as if they never regained their true footing. There are many lessons to be learned from the credit crisis that started in 2007 and the events that helped shape the landscape following the initial downturn. When embraced, these lessons are life changing. Investing through the markets and reliving the events that unfolded from 2007 through 2009 will help define the type of investor that you are.