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Mentor Monthly Missive

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Guaranteed Bonus?

It used to be such a nice, benign word. "Bonus." In Latin, it literally means "good." Way back in school, a bonus question on a test earned you extra credit if you got it right, with no penalty if you got it wrong. When tacked onto your salary, a bonus was a reward for doing your job especially well. Credit the pillagers at Merrill Lynch and now AIG with yet another epic perversion.

A bonus is no longer something you earn for a job well done. It's legalized theft. AIG, one of the most reckless corporations of all time, is now paying out $165 million in executive bonuses for 2008, the year it almost collapsed and took half the financial industry with it. But that's just garden-variety gall. The crowner, according to the New York Times and others, is that AIG is paying those bonuses to the very executives whose division singlehandedly destroyed more than $100 billion in shareholder value.

You heard that right. The bonuses go to AIG's London-based financial-products division, where hotshots sold hundreds of billions of dollars worth of derivatives that AIG couldn't back up once its fortunes turned sour last fall. The result nearly turned into an industrial-strength bank run, with parties that held the AIG derivatives suddenly asking for more and more collateral, which AIG couldn't produce.

It's 100 percent certain that AIG would have gone bust if the government hadn't stepped in with aid that now totals $170 billion and amounts to 80 percent ownership of the insurer. If the feds had simply sat by and allowed AIG to collapse, a chain reaction of failures would have rapidly brought down some of the biggest banks in the world. And all those theoretical allusions to the Great Depression would be a lot more valid.

There's no single company or division anywhere that did as much to wreck the financial markets as this relatively small group. Not Bear Stearns, not Lehman Brothers, not even Citigroup. The London traders were exploiting a regulatory loophole unique to AIG, by implying that AIG's very strong insurance units backed the derivatives sold by the financial-hucksters division. But legally, they couldn't. The shakeout exposed a huge, malignant tumor lurking in the lymph nodes of the financial system.

Now, some of the evil geniuses who incubated that cancer will earn as much as $3 million in extra pay. It's trite to say that's an outrage. It's actually the worst kind of crime - one that's legal.

Apparently, AIG is legally obligated to pay the bonuses, because of contractual deals made before the problems flared and the government got involved. I know. It's the kind of parallel-universe insanity that must have incited the peasants to gather up some tar and feathers and go hunting for the tax collectors.

If there's any good news, it's that the AIG bonus pool, no matter how odious, is relatively small compared, for example, to the $3.6 billion in bonuses Merrill Lynch is handing out - to reward its dealmakers for losing nearly $28 billion in 2008. But the AIG payouts would be horrifying if they amounted to just $1, and they're likely to do an outsized amount of harm. Here's why:

They'll generate more heat than light. We were finally making progress on another vital aspect of the AIG bailout: Learning which holders of those derivatives contracts got 100 percent of their money back, straight from taxpayer bailout funds. AIG, with government support, refused to say for awhile, but has now disclosed that firms like Societe General, Deutsche Bank, Barclays, and Goldman Sachs received $105 billion in what are essentially refunds. This is a complex issue that needs to be thoroughly plumbed, to determine if this was appropriate use of taxpayer funds. The bonus brouhaha will make it hard to do that. The tenor of upcoming Congressional hearings on AIG will indicate whether an honest hearing on all this is possible. Chances are, the politicians will spend so much time fulminating over the bonuses that the counterparty payouts - far more important and costly - will get overlooked.

The bonus brouhaha could derail necessary parts of the AIG bailout. The AIG bailout is ugly, but it's doing what it was supposed to do: Help restore confidence to the financial markets. The firm is gradually unwinding those derivatives contracts - that's where the $105 billion went - and selling off divisions and assets to pay back the government loans. It's the equivalent of a bankruptcy proceeding, with the federal government as the judge overseeing the whole mess. The bonuses will distract from all that, with the good and the bad parts of the AIG bailout sure to get conflated. Voters are already deeply tired of all the bailouts, and support for the AIG affair could turn so negative that the Obama administration has to rein it in.

Big Brother has no choice but to step in. Bonuses in general are an effective way to draw and reward top talent. But the incentive structure devised by AIG, Merrill and others is so distorted that rogue traders got rich no matter what happened to the company. AIG obviously didn't link its bonuses to the company's performance; it just guaranteed them no matter what. The backlash is likely to entail a new set of straitjacket regulations that dictate pay practices and probably go overboard, possibly harming the productivity of financial firms far into the future. Hardly anybody wants the government to redesign the financial system or start telling CEOs how to run their companies. But that's what you get when you can't police yourself.

Markets don't stay down forever

As 2009 continues the nerve-wracking stock market declines that started last year, many investors are wondering if they should get out, or stay out, of investing in stocks. The longer the stock market keeps going down, the more likely it is that investors will bail out and stay on the sidelines.

We don't know if the current bear market has reached its bottom. It's too difficult to predict when the market will hit bottom and when it will finally start to turn around. But we can look at history and see that every single market "collapse" has been followed by significant and sudden rebounds.

Take the S&P 500 Index for example. After the huge losses suffered during the Great Depression, the index gained 54% the next year and averaged a gain of 31.6% over a four-year period.

After a 35% decline in 1937, the index gained 31.1% the following year and averaged a gain of 12.6% per year over an eight-year period following that 35% drop.

After losing 14.7% and 26.5% in 1973 and 1974, the index gained 37.2% and 23.8% the following two years.

After the incredible bull market of the late 1990's the index lost over 40% from 2000 through 2002 while many investors cashed out their investments and stayed away from stocks. That turned out to be a huge mistake as the index gained 28.7% in 2003 and averaged a yearly gain of 14.7% from 2003 through 2006.

Yes, it can be difficult to stick with your investment strategy the way things are going now. However, as the previous examples show, bailing out of the stock market during times like these can prove to be a huge mistake in hindsight.

Remember what Warren Buffett once said: "Be fearful when others are greedy, and be greedy when others are fearful."

Debt to equity

Entities that want to finance their operations have two basic sources of funding: debt and equity.

Equity funding comes from the sale of stock. Investors who believe that a company's prospects are good will buy the stock, hoping to profit as the company does.

Debt funding usually takes the form of bonds. Corporations and units of local government sell bonds to the public and pay interest on those bonds at a rate that's based on their financial health. Financially healthy entities enjoy lower rates than those that are not so healthy.

Right now the federal government is enjoying the lowest rates in at least 45 years on its debt, reflecting the investing public's positive perception of Uncle Sam's financial health relative to the financial health of corporations and units of local government. Treasury bonds, notes and bills are seen as virtually risk-free investments; the federal government would have to go belly-up for holders of Treasury securities to lose their money.

As the federal government continues to go into hock to fund its bailout package(s) and stimulus plans, investors have continued to bid up the prices of Treasury securities, resulting in lower yields. It's probably more of a reflection on the risk perceived in other types of investments than on the risk of Treasuries.

At what point will investors begin to see more risk in the Treasury market? We hope no time soon. The U.S. government, and by extension the American taxpayer, benefits from low interest costs and high demand for its debt.

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