



GRAVITAS

The Advantage of Innovative Thinking

GRAVITAS Capital Advisors, Inc.



University of the West Indies Lecture Series:

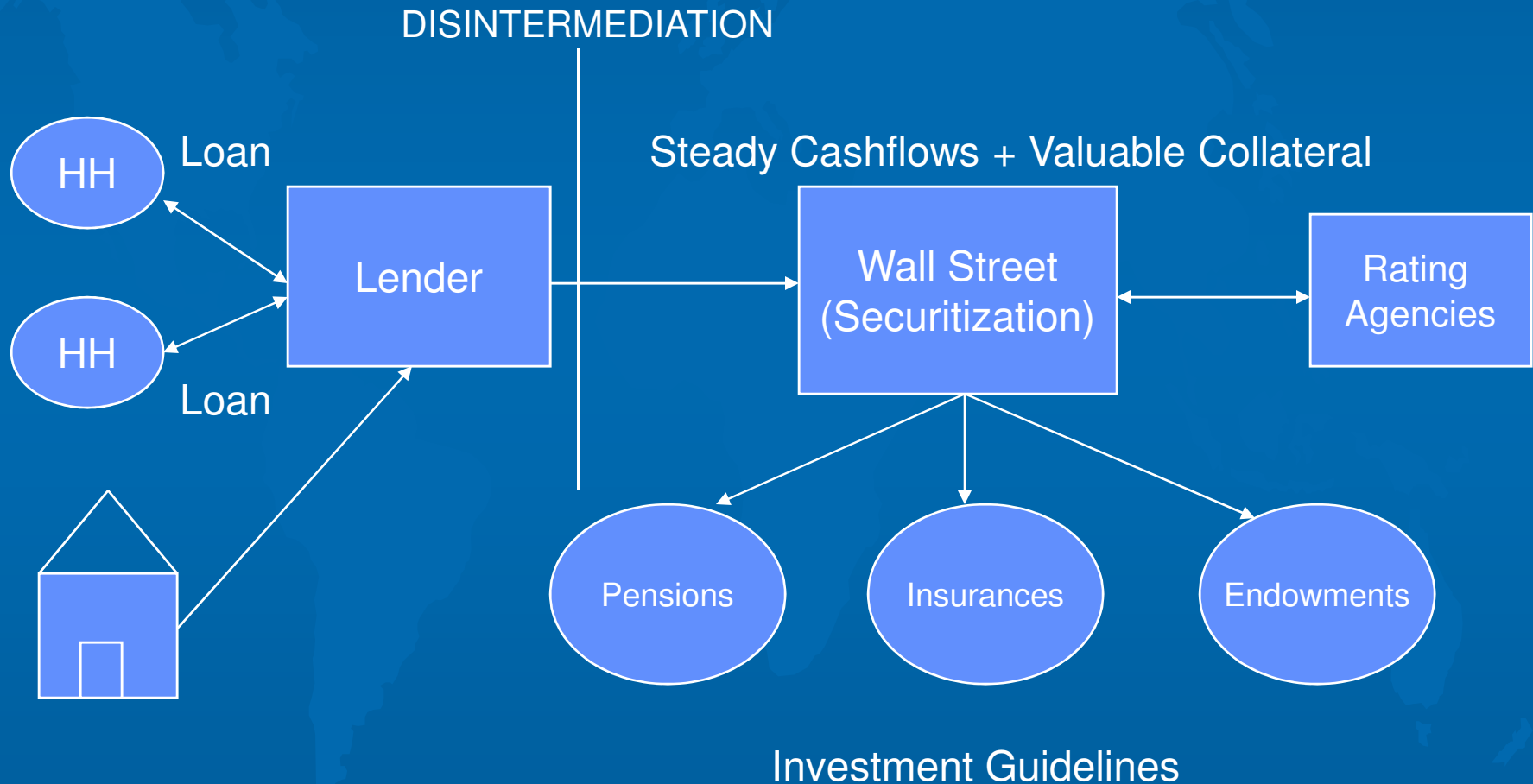
Ethics & Crisis

Presenter:
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GRAVITAS Capital
October 27 - 28, 2009
Trinidad & Tobago

CNBC: House of Cards

(video preview)

The Perfect Ethical Storm: The US Mortgage Market



Context breeds Temptation

- ◆ Private banks enter sub-prime mortgage origination after years of lobbying. But don't have the vetting infrastructure in place to secure quality (FNMA/Freddie Mac)
- ◆ Mortgage origination rules are made lax
- ◆ Pay-for-volume origination overwhelms cares of due diligence
- ◆ Key Players?



Lender: Countrywide

- ◆ Founded in 90s. Went from insignificant mortgage origination player to key supplier of “product” to Wall Street in 00s.
- ◆ Made billions of dollars in “toxic” loans.
- ◆ Angelo Mozilo (founder) paid himself US\$50 mil + in annual salary
- ◆ Pocketing US\$140 mil in '08 before being arrested for fraud by the US SEC.

Appraiser: Banks

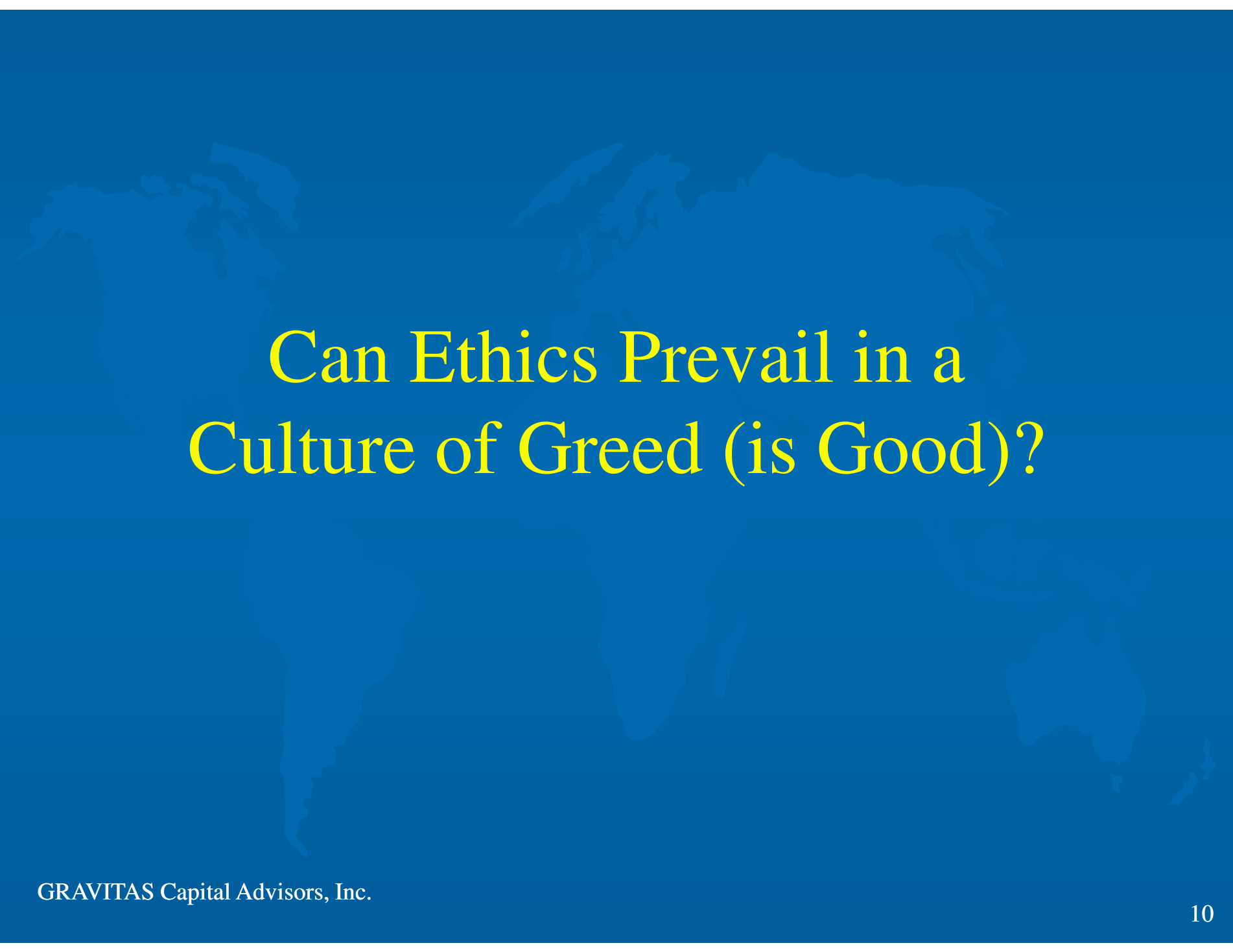
- ◆ Residential housing known to grow annually at 5%-6% per annum (inflation hedge)
- ◆ But, between 2001 – 2008 residential houses inexplicably increased in value by 300%
- ◆ Why?
- ◆ Appraisers worked for Banks and Banks had to make loans....large Jumbo loans (Wall Street)
- ◆ NB: States and Counties got into the act as well!!

Financier: Wall Street

- ◆ Prevailing interest rates were low (Greenspan was fighting global deflation)
- ◆ Pension, Insurance and Institutional Investors were clamoring for higher returns/yields
- ◆ Where to get them?
- ◆ High Yield instruments = Sub-prime mortgages (untapped market)
- ◆ Belief in risk mitigation with mathematical models (pooling, tranching and securitizing)

The Fall Out?

- ◆ 109 banks have closed in 2009 alone. A total of more than 500 are expected to close before crisis is over
- ◆ Lehman, Bear Stearns, Countrywide, Merrill Lynch, Hedge funds, Charities...have all disappeared or taken over
- ◆ “Official” unemployment stands at close to 10%
- ◆ Estimated loss in value: US\$14 trillion.



Can Ethics Prevail in a Culture of Greed (is Good)?



Tylenol Tampering Case

- ◆ 1982 Tylenol pain-killer capsules were tampered with in Chicago. Seven people died of cyanide poisoning after taking Tylenol capsules.
- ◆ Capsules were taken from the shelves in stores, filled with poison and put back on shelves.
- ◆ Johnson & Johnson the pharmaceutical company producer of Tylenol, was the leading medicine producer in the US with 37% market share.
- ◆ What did it do? How would you deal with this crisis?

What did Johnson & Johnson do?

- ◆ Once the connection was confirmed, they informed the public not to consume Tylenol.
- ◆ They pulled all Tylenol capsule containers from the shelves all over the country. This was 31 million bottles and incurred a loss of \$100 million.
- ◆ They halted all Tylenol advertisements.
- ◆ Was this excessive and did it destroy the reputation of the firm and its leading product?

Outcome and Why?

- ◆ Tylenol lost almost all market share – ending at 7% in 1986. However, with careful reintroduction it regained its leadership role. Why?
- ◆ Trust. Public felt it could trust a company that would protect people first, property second.
- ◆ Tylenol and J&J are most trusted brands in the US.
- ◆ What dictated J&J actions during this destructive crisis? The firm Credo etched into the entrance hall of it's headquarters in NJ.



Johnson & Johnson Credo



Stanford Financial Case



◆ Allegedly:

- Accumulated retail deposits by promising high yield returns and liquidity from an Antigua based financial operation;
- Invested in highly illiquid investment (fraud);
- Embezzled depositors funds used for personal spending and political influence.



GraceKennedy First Global Case

- ◆ Allegedly:
 - Discovered breach in trading operations with potential US\$19 mil exposure;
 - Douglas Orane - Chairman immediately communicated to stakeholders (public, depositors, central bank, investors...);
 - Dismissed senior staff and accepted CEO resignation;
 - GK Restored confidence.

Key Lessons:

- ◆ Corporate culture determines fate
- ◆ Values and where they are placed affect behavior and outcomes
- ◆ Transparency in crisis is half the solution
- ◆ Protect people first, property second.