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Leaders have to lead

David Abrams, a top-flight Boston investor whose nearly invisible public profile led *The Wall Street Journal* last year to speculate that he might be a unicorn, sat on stage at the Plaza Hotel fielding questions. As Abrams Capital invests eclectically, so were the questions varied.

One concerned Fannie Mae and Freddie Mac. The price for the preferred shares was two to four cents on the dollar when Abrams got involved, the founder of Abrams Capital related. Things were prospering—the company and the shares—until, in 2012, the government announced that to it, not to the private investors, would henceforth flow the profits. Lawyers manned their battle stations.

Abrams was asked if hell would freeze over before the Obama administration allowed the hedge fund community to cash a check on its Fannie and Freddie speculations.

"That sounds like a reasonable bet," our speaker replied. Then, again, politics change, and legal judgments are under appeal, he said: "One of the things I've learned over the years is that with a lot of securities, you have to buy them when nobody wants them. Even Fannie and Freddie, where there are many billions of face of the preferreds and a decent amount of the common, it only trades when there is news, and it only trades down when there is bad news. We first bought our stock in 2010 on the bad news that the stocks were being delisted.

"I have no idea whether there will be anything in the next 12 to 24 months," Abrams went on. "This thing could end up being a complete zero. That's technically what they are worth now based on the terms of the preferred, although I think that someday there [will be] interesting optionality because some administration—not the Obama administration—is going to decide that having the linchpins of the U.S. mortgage market in bankruptcy (these companies aren't going anywhere) is not a clever idea. When they do, they will have to deal with the junior securities."

How, if at all, was he dealing with the plunge in energy prices? His firm is mostly uninvolved, Abrams replied. The debt securities aren't especially cheap, and billions of dollars—$40 billion, he had heard—has been raised to bottom fish. Besides, said Abrams, he tries to avoid investments whose success depends on the price of a commodity.

"If you remember," he continued, "for those of you who were around in the 1980s, the price of oil fell and there were three waves of bottom fishers. The first ones bought and they got smoked. The second one bought and they got smoked. The third one bought and they got smoked. Finally, like 10 or 15 years later, oil went up and people made some money in energy. It's not my cup of tea, particularly."

There are exceptions, Abrams allowed, for example in the preferred shares of Surgutneftegas, a controversial Russian oil and gas company that's valued in the market at a discount to its net cash. (Let the record show that Abrams only mentioned this position because your editor twisted his arm to mention some position.)

"The preferred we own pays a hefty dividend," he said. "They are trading at 46 rubles. The dividend gets calculated at the end of the year, and it gets paid in the summer. It is not entirely clear what it is going to be, but we think it is going to be about eight rubles per share. When you take the market cap of the preferred and the common—there's $34 billion of cash—it is trading around $32 billion, at a discount to the cash. There is no debt. No value to the business."

Any opportunities in fixed income?

Not on the long side, Abrams replied. "The opportunities, to the extent that someone would want to capture them, are on the short side. If you just start with Treasurys and government bonds from all developed countries around the world, you have securities that are the opposite of what an investor tries to do. Usually, you want a security with not that much risk and a lot of return. Here you have a whole class—the most important class in some way—that, very clearly, mathematically, has very little return and tons of risk."

Not that it's so easy to get off a short sale, Abrams continued. You have to be cognizant of the probability of being right. And you have to be clear-sighted about the prospective payoff. "In Japanese government bonds," he said, "we only do structures where, if rates move, say, 200 basis points, we can make between 15:1 and 20:1. That comes and goes in the market. It is not that easy to do it."

"What would you say," came a question from the audience, "to a traditional, long-only, balanced manager after 33 years of declining interest rates? The long-only manager is mandated to have a balanced portfolio. What should he be doing with his bond holdings?"

"I would suck it up and go really short, really safe, if you have a mandate to be in bonds," Abrams answered him. "Tell your clients it is not my fault and I am protecting you. I have an expression I use around our firm: Leaders have to lead. If people have given you money to invest, they've hired you for a lot of things. In part, they've hired you for your judgment. My opinion is that you're doing them a terrible disservice if you cop out and say, 'My clients made me do it.' No, your clients didn't make you do it. You did it. Whatever you do, you have to own that. Leaders have to lead."

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