



The End of the Affair

“I feel sorry for the person who can’t get genuinely excited about his work. Not only will he never be satisfied, but he will never achieve anything worthwhile.”

--Walter Chrysler

“The greatest thrill that life offers is to create, to construct, to develop something useful. Too often we fail to recognize and pay tribute to the creative spirit. It is that spirit that creates our jobs.”

--Alfred P. Sloan

The End of the Affair is Graham Greene’s wartime novel of illicit romance, infidelity, and the struggles of conscience. In light of the two lead-in quotations, one might think of this title in terms of the end of America’s long love affair with the many beautiful cars that our national automotive companies have produced. That would be perfectly natural. My meaning, however, is a different one. I refer to the end of the rule of law and the abrogation of contracts. The economic environment that permitted Walter Chrysler and Alfred Sloan to give form to their dreams and create the Chrysler Corporation and take GM from near insolvency to decades of prosperity had very simple origins. The United States is a country of laws based on the notion of property rights backed by a government and a legal system that is designed to defend those rights. Critical to that is the notion of contracts. With the government arranged bankruptcies of Chrysler and GM we have seen an unprecedented disregard for contractual rights. The holders of each company’s senior debt have seen their claims diminished by Government fiat in favor of the company’s incumbent work force. While the motives for this action may have been genuinely noble, its effect on capital markets can only be chilling. It is not my intent to disparage or minimize the pain of the losses for any of the parties involved. In terms of the priority claims under the law, all claims of the secured debt holders are to be settled before any labor contract claims are settled. In the current proceedings, the employees of GM and Chrysler will effectively own more of the restructured companies than will the prior debt holders. We have turned contract law and the traditional concept of capital structure on their heads. We have politicized the bankruptcy process. Bankruptcy is a legal process, not a political one. Once again we see our Government entering a private process to determine who the winners and losers should be. By what right does the Government do this? By what standards are the limited spoils to be divided and why is the prescribed division superior to the terms previously understood and agreed to by all parties under contract law and the priority of claims customarily dictated by capital structure?

If we think of entrepreneurs with a dream to start a business but in need of capital, we have made it less likely that they will be to secure any type of capital markets based debt financing. By showing ourselves to be willing to ignore the terms of bond covenants, we



certainly make it difficult for the prospective debt investor to have confidence that their repayment claims will be adjudicated fairly. This is bad policy at any time, let alone when the country is in recession and is reliant on businesses for job creation. The concepts of property rights and contracts are not abstractions. They are essential elements of the commerce that has permitted the prosperity of the United States and western civilization as a whole. Walls are built and walls come down brick by brick. We ignore them at our own peril and to our own detriment. This is what I mean by the end of the affair.

Walter Chrysler and Alfred Sloan were giants of the U.S. auto industry. Chrysler resurrected a moribund Maxwell Motors, transforming it into the Chrysler Corporation. One of our country's most beautiful buildings, the Chrysler Building in New York City, bears his name. Alfred Sloan ran General Motors for several decades and is justly credited with having saved the company from insolvency in the 1920's. His book, My Years with General Motors, is viewed as a treatise on how to run a business and remains standard reading at many business schools in the United States. The MIT Sloan School of Industrial Management and Sloan-Kettering Institute and Cancer Center in New York were both made possible by his largesse and vision. Both men achieved high levels of financial success and were leading philanthropists. They were pioneers in their industry and operated in an era during which entrepreneurial spirit was rewarded and the primary constraints on American businessman were the limits of their own imaginations. Sadly, that era appears to be over, as symbolized by the recent bankruptcy filings of their respective companies.

I have generally viewed the spate of Government bailouts unfavorably. We were told that the economy would face dire consequences were we to let General Motors or Chrysler go bankrupt. On their face the arguments in favor of bailing them out were not without merit. GM and Chrysler were large customers of many smaller parts companies who employed millions and were themselves on fragile ground. What about warranties? Who would buy an automobile from a company in bankruptcy, when you could buy from a more stable company who seems better positioned to honor their service commitments? Permitting them to enter bankruptcy would trigger a further decline in their sales and push many of their suppliers over the edge. We were all reminded that a prior Government bailout loan to Chrysler had saved that company. All of this seems reasonable and logical. A couple of counter arguments to this logic seem obvious, however. First, when a company is teetering on the verge of bankruptcy, a guarantee from the U.S. Congress is unlikely to be viewed as permanent solution, unless you wish to nationalize the company and make it a ward of the state. Most buyers would not view it as something that would endure for five years or whatever the warranty term may happen to be is. If the perception remains that the product is not desirable or the company is not viable, no one would purchase their product anyway. One of the great ironies of this whole affair is that at the onset of this crisis GM and Chrysler were making some of the best vehicles in terms of both quality and styling that they had in decades. Both companies' product lineups seemed attractive and viable.



A second issue is that by failing to let market forces and the consumer dictate what companies will survive, we have the U.S. Government stepping in to pick winners and losers. It would seem that the Ford Motor Company and any foreign domiciled carmakers selling their products here would benefit from the demise of Chrysler and General Motors. Many of the foreign makers have invested significant capital to build their cars here and employ American workers in doing so. Is it fair to them to have the government bailing out their competitors? By what Constitutional authority does the federal government seek to intervene in the private affairs of its citizens and corporations anyway?

The primary fallacy with the bailout mentality is that people were equating a bankruptcy filing with liquidation. This need not and generally is not, the case in most corporate bankruptcy filings. Despite this the federal government gave GM \$20 billion before they filed for bankruptcy protection on June 1st. Since the filing the Government has pledged an additional \$30 billion in debtor-in-possession financing to GM. Chrysler received \$4 billion prior to filing for bankruptcy on April 30th. Since that time they have received a pledge from the Government for an additional \$8 billion in debt financing. The takeaways that one should glean from this are that both companies filed for bankruptcy despite receiving government aid and that both companies continue to produce and sell cars despite their having filed. The warnings of the dire consequences that bankruptcy would entail drove the Governmental aid in the first place, and have proven to be overstated. Both companies remain in business today.

Many reasons may be cited for the difficulties experienced by GM and Chrysler, and I do not intend to explore them in any detail. A couple of general observations do seem worthy of comment, as they may have implications that reach beyond the auto industry. The critical issue that both companies faced is that they struggled to sell enough cars at a high enough contribution margin to cover their obligations. Part of this problem was that promises made to generations of retirees and current employees when sales and profitably were higher proved crushing as vehicle sales declined. The drop-off in sales caused by spiking oil prices in the first half of last year and the subsequent recession thwarted a concerted effort by the companies over the past several years to bring their cost structures into line. Industry reports have estimated the Big Three's cost disadvantage due to legacy contract costs at anywhere from \$1,400 to \$2,000 per vehicle relative to the costs of Toyota, Honda, or Nissan vehicles assembled and sold in the U.S.

It is a basic tenet in labor economics that workers will earn the value of their marginal physical product in an efficient labor market. This is a very powerful notion that has broad social impact. Consider the question: Why are poor people poor? Someone of a liberal political orientation might offer that poor people are disadvantaged, come from broken homes, may have some disability, or were somehow failed by society. A conservative might offer that they have been profligate, lazy, or failed to take advantage of the opportunities that society had to offer. The truth is likely somewhere in the middle. The verdict of labor economics contains no value judgment at all. It is quite



simply that poor people are poor because society does not value what they do. The implication for social policy is that we cannot solve poverty by giving money to the poor. The only way that we can end poverty is to teach people the skills necessary such that they have something to exchange that society will value – namely, their labor. Thus it is that we see the enduring wisdom of the ancient Chinese proverb “Give a man a fish and you feed him for a day. Teach a man to fish and you feed him for a lifetime.”

In hindsight the automakers and their workers would have done well to focus on the here and now and to have avoided entering the realm of making promises to pay for future benefits over their workers’ remaining lifetimes. To make such promises requires assumptions regarding many factors such as cost escalation, morbidity, mortality and so forth. The necessary assumptions are difficult to forecast with any precision and we would do better to pay people the value of their marginal physical product and let them adjust their expenditures to provide for the uncertainties of their own future. After all, no one can sustainably earn more than the value of their marginal physical product indefinitely if a labor market is to maintain equilibrium. In the context of the Alfred Sloan quotation that I opened with, the nature of the relationship became too far removed from the creative spirit that created the underlying jobs, and the profit per vehicle that was required to keep things going became disconnected from the price per vehicle that could be charged in a competitive marketplace.

Bernard Madoff has reintroduced the investing public and society at large to the concept of a Ponzi scheme. One of my professors in business school used to refer to the concept of Ponzi finance. By that he meant that no one part of a financial system could grow faster than the system as a whole in perpetuity. This accounts for why every asset bubble must eventually break. With the benefit of hindsight, we can see that GM and Chrysler were brought down by cost structures that were predicated on an assumption that their fortunes would continue to ride high. Think about it. Managements will offer and labor groups receive the most generous compensation packages when a company’s fortunes are at their peak. Unless there is a means of adjusting those packages when fortunes deteriorate, the results can be fatal for both the enterprise and the continuation of the labor relationship.

The implications for social policy seem obvious. We are approaching some large funding deficits in Medicare and Social Security that we cannot simply wish away or continue to kick down the road. The fiscal 2009 (fiscal year ending September 30, 2009) federal deficit stood at \$1.378 trillion at the end of August. We learned after Labor Day that the White House’s ten-year budget deficit forecast has been revised upward by \$2 trillion to \$9.05 trillion from the forecast that they gave just six months ago. We enacted the American Recovery and Reinvestment Act of 2009 this past February. The so-called Stimulus Bill committed \$787 billion of U.S. taxpayers’ money for a variety of uses. As of June, only 6% of the appropriated funds had been spent. As of the end of August the percentage spent had risen to 15%, just as Newsweek magazine had made it the focal point of their August 3rd issue to declare that the recession was probably over. One would have hoped that our Representatives and Senators would decide not to spend the undistributed monies, but that is not the nature of politicians. Instead our national leaders



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stand poised to launch a massive overhaul of our healthcare system that is likely to lead ultimately to a single-payer nationalized system. Any honest accounting of such a proposal's fiscal impact indicates that it would add massively to our already massive national debt, yet we entertain fairy tale notions that entitlements can be granted without cost or that our federal government could somehow save costs to pay for new benefits conferred. As Milton Friedman so famously noted, there is no such thing as a free lunch. Either taxes and other costs will have to be raised to pay for new beneficiaries, services will have to be rationed or cut for existing beneficiaries, or additional debt must be taken on to pay for them. There is no other way. Within the context of society as a whole, no one is going to get something for nothing. They will pay for it themselves, other participants in the system will have to pay for it, or it will be paid by future generations. No part of the system can grow faster than the system as a whole indefinitely. That, however, is a topic for another day.

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