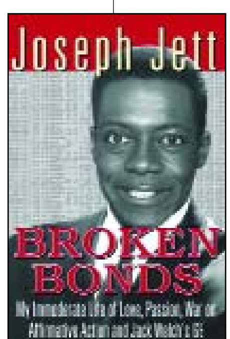
By Aaron Brown

Broken Bonds

Author: Joseph Jett **Publisher:** Cambridge Matrix, Feb. 2004 **ISBN:** 0907081013X

Of all the financial disasters in recent decades, only the demise of Kidder Peabody supports a thriving conspiracy-theory industry. Some debacles are contained efficiently by deep-pocketed institutions and regulators, with a neat official story. This happened, for example, at Metallgesellschaft, Barings and Long-Term Capital Management. Other scandals, like Drexel, Banker's Trust and Enron, spawn extensive civil and criminal litigation. Adversarial proceedings ensure evidence gets to the public domain.

General Electric bought 80% of Kidder Peabody in 1986 for $620 million, then paid $550 million for the remaining 20% in a 1990 bailout. It was a troubled investment from the beginning, as the brokerage became embroiled in a series of scandals; even worse, nearly every department in Kidder appeared to be losing money.



Then, in April 1994, GE announced that one of Kidder's two apparently profitable divisions – the government securities trading desk run by Joseph Jett – had not made the $264 million reported over the past 33 months; instead, it had actually lost $75 million[1]. Over the course of 1994, GE closed down Kidder's trading operations and transferred the banking assets to Paine Webber in return for 25% of PW's stock.

Broken Bonds is Jett's second account of the events at Kidder. In this book, Jett fights back against his former employer with three main claims: first, that his trading actually made money – perhaps not the full $264 million, but a substantial portion of it; second, that he accounted for his trades as directed by his superiors, who wanted to inflate profits and shrink the balance sheet; third, that the real problems in the firm were caused by Mike Vranos's mortgage trading operation, the other supposedly profitable division in Kidder.

One of the most puzzling aspects of the Kidder fiasco is why Jett didn't cut any deals. Jett didn't save any documents and refused to enter into any alliances. His failure to do either has led to speculation that either he had absolutely no defense at all or he really didn't believe anything problematic was going on.

Jack Welch, CEO of GE, was one potential ally. In his biography, Welch discusses his affection for loyal GE business heads who offered to manipulate their own numbers to conceal the Kidder problems. And Jett could have given Welch chapter and verse on who ordered what, for what end. But he did not understand that Welch cared about minimizing the reputational damage to GE and maximizing the remaining value of Kidder.

In *Broken Bonds,* Jett talks about Welch in terms that suggest Welch should have been worrying about justice for Jett instead. From Jett's view, Welch orchestrated a vicious conspiracy that ruined Jett's life. From Welch's point of view, and that of GE shareholders, the clean-up operation went very well.

Inside Kidder

Jett's testimony was a powerful bargaining chip to a federal prosecutor, because, in Broken Bonds, he raises legitimate questions about the role of upper management in the high-profile Kidder scandal. But when the Justice Department wanted to talk, Jett angrily refused.

Simply put, Jett seemed to lack the capacity for any alliance. Further proof of this could be found inside Kidder. Jett could have closed ranks with Melvin Mullin and Ed Cerullo – but decided against joining forces with his former Kidder bosses.

One of the hardest things for GE and the SEC to explain is why Jett had to give back the portion of his bonus relating to the problematic trades, but his supervisors didn't have to give back their shares for the same trades. Some of the most incredible testimony concerned Mullin and Cerullo's denial of any knowledge of anything Jett did. It would have been more natural to join all three actors, and maybe David Bernstein and Michael Carpenter, and call them innocent or guilty together.

But apparently it never occurred to Jett to think about how the Kidder affair looked to other people and how he might profit from that. Jett offers persuasive explanations of some of the details against him, such as the firing of a trader who complained about Jett's accounting and the offering of quadruple sales concessions and no bid/ask spread (an impossible way to make money but a great way to disguise the fact that your profits aren't coming from customer business). He also repeatedly refers to repos as "repossession" instead of "repurchase" agreements, an inexplicable error for the head of a government bond desk who actually wrote the book himself.

However, neither behaving like an innocent man nor explaining some of the suspicious details makes Jett innocent. For 10 years now, Jett (and GE) have failed to supply a monthly P&L listing, stripping out the forward recon trades; nor has anyone provided the simple mathematical details necessary to determine if Jett made money or not.

The account Jett gives in this book is that he bought STRIPS and hedged them with treasury futures. One of the few useful details dredged up from public transcripts of his hearings is that the weighted average coupon on his recons was 10.5%. That was considerably higher than the current coupons during the period. Depending on how the hedge was run, that probably meant Jett was betting on a steep yield curve. Essentially he was earning a 10-year interest rate and funding with shorter-term liabilities, duration-hedged but twist-exposed.

While it's conceivable Jett could have sneaked phony trades past Kidder's anemic financial control system, it's very implausible that they could have evaded the risk management system unless they were at least duration hedged. It also explains why neither side is disclosing the numbers: GE's story looks weak if Jett's position was ever up more than $100 million or so, and Jett refuses to admit he ever lost money except when the firm forced him in a distress liquidation of $30 billion in assets.

If this is true, then Jett's forward recon trades were made, as he claims, to accelerate profits (and also, though he doesn't mention this, to conceal risk). He really did intend to convert the STRIPS to bonds, or sell off the position first. Jett admits that many of the forward recon trades were not related to real deals, but says (convincingly in light of the evidence) that he was ordered to do those to reduce the firm's capital and make it appear less risky and more profitable.

In economic terms, the forward recon trade distorts the accounting, but a standard booking is distorted in the opposite direction. If the above speculation is correct, it's hard to fault Jett for picking the most advantageous accounting allowed by the firm's system, few traders fail to do so. If the accounting is not clearly wrong, it's not the trader's job to worry about it.

However, the real charge against Jett is not that he allowed bad accounting, but that he manipulated the accounting. If he entered forward recon trades for no reason but to increase his reported profit, then it doesn't matter whether they were arguably correct. It's the pattern of the forward recon trade entry relative to his real trades that matters. Neither Jett nor GE ever showed this. GE did demonstrate that the forward recons increased over time and argued this showed Jett was using them to hide past losses. But Jett's limits and real positions were increasing at this same time, and the balance sheet games the firm asked him to play required increased juggling as well.

At best, this means Jett might have been a reckless – rather than fraudulent – trader and a good-soldier accounting cheat instead of a greedy one. That makes him no worse than a lot of other people, but hardly a figure of great sympathy. Guiltier people were treated better than Jett, but more innocent ones were also treated worse.

For risk managers interested in the Kidder debacle, the climax of frustration came when GE admitted it destroyed the computer system at the heart of the controversy, because GE "lacked the economic resources" to store a program that fit on a 1990-era PC hard drive and ran on a single PC.

Truth or Fiction?

In 1999, Jett wrote Black and White on Wall Street, covering much of the same ground as his latest book offering. But *Broken Bonds* is superior, partly because it goes into more detail about the events at Kidder.

Jett is a talented author – but the question is whether the stories he recalls are fiction or non-fiction. Overall, I think *Broken Bonds* presents an honest picture of Jett, though not precisely the one he tries to paint. In his three investment banking jobs, Jett describes complex and intense politics, but contradicts himself. On one page someone is trying to destroy Jett in a devious plot; on the next page, the person appears as a benevolent mentor that Jett trusts completely; and on the next page, he goes back to the first account. Jett consistently trusts the wrong people and betrays his potential friends. The book explains why Jett, despite his impressive resume and accomplishments, was fired from all three jobs.

Financial disaster junkies will find *Broken Bonds* an indispensable read. It's not wholly believable, but you read autobiography for personal insight, not factual detail. On that score, Jett delivers in spades. ■

FOOTNOTES:

1) This is not precisely true; the loss announced at the time was $85 million and has changed constantly, without explanation, throughout the 10 years since. However, $74.7 million seems to be GE's final answer.

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