

THE REPRICING OF COMMON SENSE

FOR QUARTER ENDING SEPTEMBER 30, 2007

The recent turmoil in the stock and bond markets has commonly been referred to as the “repricing of risk.” The usual premium that the markets demand for riskier assets practically disappeared over the last few years, evidence that investors were paying little attention to risk. However, this is no longer the case. The so-called repricing of risk that we experienced this quarter manifested itself in lower market prices across all asset classes. The credit markets were hit particularly hard.

The first sign of weakness came last year when real estate prices began to flatten out and mortgage delinquencies rose. Delinquencies continued to rise in 2007 and had reached record levels by the second quarter. As you would expect, the subprime borrowers were the first to feel the pain. However, this pain spread quickly, touching many countries and industries that, at first glance, would appear to be far removed from the world of subprime lending in the U.S. In the course of a few months, the subprime problem forced the closure of a number of hedge funds, sent over 100 mortgage lenders into bankruptcy and led to the bailout of several foreign banks. The pain experienced thus far may still be the tip of the iceberg as billions of dollars in subprime adjustable rate loans are due to reset over the next 12 months.

One thing that has become abundantly clear is that the current repricing of risk is a realization that, once again, the market became bloated with excess. Unlike the tech bubble, the latest example of market excess has the potential to cause real damage to the American dream of home ownership. Similar to the tech bubble, the latest market excess is marked by greed and the abandonment of common sense for the sake of a quick profit.

Out of the Shadows

The recent credit market meltdown has illuminated the existence of an unregulated alternative banking system. Pimco’s Paul McCulley named this alternative source of liquidity “the shadow banking system.” The alternative banking system seems to have operated in an environment that was somewhat immune to the actions of the Federal Reserve and contributed greatly to the housing inflation that we have experienced over the last ten years.

Subprime borrowers found a consistent source of funding in the alternative banking system void of the normal scrutiny they received in the traditional banks and S&Ls. The creative shadow bankers developed new loan vehicles to entice more and more subprime borrowers into the real estate market. The focus of the sales pitch was on low monthly payments for the borrowers. Why rent if it costs more than owning a house?

In order to attract new homebuyers as real estate prices rose, the mortgage industry began pushing adjustable rate mortgages (ARMs) that reset to a fixed rate after 3 to 5 years, depending upon the terms of the loan. The interest rate during the initial 3 to 5 year period was well below the going fixed-rate mortgage. In some instances, the initial interest rates were 3% or lower. These types of loans worked well for borrowers when interest rates were steady and housing prices were increasing. Frequently, borrowers would simply take out a new 3-year adjustable rate mortgage when the loan was due to reset to a fixed rate.

As home prices continued to rise, mortgage lenders needed a new way to keep monthly payments low for borrowers. A new type of

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adjustable rate mortgage began to gain popularity with lenders. The option ARM gave borrowers the flexibility of making one of several possible payments. In some cases, the minimum required payment did not cover the interest due. While these loans reduced the monthly payments, the unpaid interest was added onto the outstanding principal creating a negative amortization loan. Borrowers ended up owing more than the initial loan balance. The use of option ARMs grew quickly and brought a whole new group of buyers into the housing market, extending the boom longer than it would have otherwise lasted.

Option ARMs also benefited the mortgage lenders. These types of mortgages typically had higher payouts to mortgage brokers and loan originators. In addition, the lender is allowed to claim the highest payment option as income on the loan regardless of the option that the borrower actually selects to pay. This resulted in large phantom profits for the banks, but this treatment is allowed under generally accepted accounting principles. The lender incentives combined with the low payments for the borrowers contributed to the soaring popularity of option ARMs in recent years.

Deep Pockets

In order to keep the profits flowing, the shadow banks needed a steady source of liquidity with which to originate mortgages, and the ever-adroit investment banks were ready and willing to step up. The mortgage companies first needed short-term funds to originate the loans, and then willing investors to purchase the mortgages. The investment banks were able to fulfill both needs.

The non-bank mortgage companies were able to float 30-day commercial paper to raise the cash necessary to originate mortgage loans. Once the mortgage was on the books, the loans were sent to the investment banks where they were pooled together with other subprime mortgages and sold to investors. The cycle then repeated itself and underwriting standards began to deteriorate to keep the deal flow active.

Lipstick On The Pig

As adept as the investment banks are at marketing structured financial products, there is still limited demand for securities backed by poor credit quality subprime mortgages. Although many hedge funds were willing to take the higher risk (and higher return) associated with subprime paper, the investment banks needed a way to market these securities to the broader community of institutional investors. The credit rating agencies proved to be the key to opening the door to the institutional community.

The investment banks divided the pools of subprime mortgages into separate classes or tranches. The highest class were first to receive monthly mortgage payments. The next class began receiving payments only after the highest class was fully paid and so on down the line. Therefore, any mortgage delinquencies or defaults hit the lowest class first. As a result, the lower classes of the mortgage security took more risk and earned a higher yield than the upper classes. The credit rating agencies in turn rated the highest classes with the most attractive AAA credit scores. The law of large numbers was the rationale for allowing a pool of mortgages from the weakest borrowers to garner the most prestigious AAA rating.

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It has been reported that initially the credit rating agencies leaned heavily on the investment banks that were underwriting the subprime mortgage-backed securities. However, if the agencies overly scrutinized the issue, the banks would shop around until they received the desired rating. The subprime market has been lucrative for the credit rating firms. Compared with their traditional business of rating corporate and municipal bonds, the agencies receive nearly two times the fees from a mortgage-backed security.

It is now obvious that the credit-rating firms bowed to the pressures exerted by the investment banks. The liquidity supplied by institutional investors was a key to the viability of the shadow banking system. The AAA credit rating was critical in the marketability of subprime paper to the institutional community. The rating agencies have now admitted they made mistakes when rating subprime backed securities. In an acknowledgment that it severely misjudged the risk of bonds tied to subprime mortgages, Standard & Poor's Ratings Service said it slashed the credit ratings on hundreds of bond issues worth around \$12 billion because of mounting delinquencies on the underlying mortgages.

This is not the first time the rating agencies have let investors down. Recall how both Enron and WorldCom retained their investment-grade credit ratings long after their respective scams began to unravel. The rating agencies play an important role in our capital markets, and many investors rely on the credit rating to be unbiased and independent. At best, the rating agencies' independence is now in question. The accounting industry took most of the heat for conflicts of interest in the Enron and

WorldCom scandals. It is time to hold the credit rating agencies accountable for their failures.

There are two possible paths for the credit rating agencies. They can act seriously to reform their business models in an attempt to restore their reputation of independence. This is the route that was successful for the accounting industry in the wake of the Enron and WorldCom scandals. However, the accountants were forced by regulation into this solution. The alternative for the rating agencies is to accept the status quo, which will relegate their work to being perceived as interesting opinions with an assumed bias – much like sell-side equity research today.

Down Goes Frazier

Similar to the quick and unexpected punch that Muhammad Ali delivered to Joe Frazier in their infamous boxing match, several prominent hedge funds and banks felt the full weight of the credit crises in June as the practice of “mark-to-model” came to a sudden end. Mark-to-model is a technique used to value illiquid investments in the absence of secondary market quotes. The subprime mortgage-backed securities were normally purchased directly from the underwriting investment banks with very limited trading on the secondary markets. In order to value these securities, hedge funds and many institutional investors priced the subprime bonds using a “model” to estimate how the bonds should be priced in relation to other fixed-income securities. Although subprime delinquency rates had risen to record levels, the pricing models did not reflect the weakness. This obvious inconsistency prompted Warren Buffet to rename the pricing technique as “mark-to-myth”.

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The “mark-to-model” pricing began to unravel when a few hedge funds were forced to sell a portion of their subprime holdings in the secondary market to meet shareholder redemption requests. This action suddenly created a real secondary market for many of the subprime mortgage securities. Now, other holders of these bonds were forced to use the legitimate market prices to value their securities. Losses in the market value of subprime securities accumulated quickly, which caused even more redemption requests from hedge fund shareholders. It was shortly after the emergence of the secondary market prices that we began to see headlines of prominent hedge funds closing down and the bail out of several foreign banks who had taken large positions in subprime residential mortgage-backed securities.

An Old New World

Supporting the alternative banking system was a consistently rising real estate market and creative financial products that provided for low monthly mortgage payments. Even the Federal Reserve’s actions had limited influence upon the ability of subprime borrowers to find mortgages with low monthly payments. Eventually, real estate prices began to flatten, which made it difficult or impossible for many subprime borrowers to refinance their adjustable rate mortgages. As things began to unwind, the funding necessary to support the alternative banking system quickly dried up. Subprime borrowers were forced backed to the traditional sources of conforming mortgages. The full weight of the Federal Reserve’s interest rate increases over the past two years was felt all at once. Borrowers now face significantly higher

interest rates and monthly payments. The days of rolling from ARM teaser rate to teaser rate appear to be over.

The tighter mortgage credit conditions and weak real estate market are unlikely to end anytime soon. A record number of adjustable rate mortgage resets are expected over the next 12 months, and subprime mortgage lending has pretty much dried up. Lending for the “Alt-A” mortgage, which requires no income documentation, has also shut down. Jumbo mortgage applications are reported to be facing much more scrutiny as well. There is also a glut of unsold homes in many of the once red hot real estate markets. Some of these markets have seen declines in home values as high as 30%.

The Federal Reserve, Congress and the President are trying to save the day. The Fed’s unexpected and controversial 0.50% cut in the Fed Funds rate is an attempt to ease the burden. Congress is considering legislation aimed at protecting borrowers from unscrupulous lenders, and the President wants to bail out borrowers who are at risk of losing their homes. We can expect to see much more on the legislative front. In an election year, it is just too tempting for politicians to try to “solve” the problem. Unfortunately, this means that the unwise borrowers and lenders will not have to face the full consequences of their actions. The reckless are being bailed out at the expense of the prudent. As is usual, the American taxpayer will ultimately be the one left holding the bill at the end of the party.

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Staying the Course

On Wall Street, common sense appears to be another cyclical commodity. Emotions in the stock market tend to oscillate, and common sense becomes most prevalent during the periods when fear and greed are in equilibrium. Hopefully, we are entering an extended period of equilibrium. As contrarian value-oriented investors, common sense is critical to our long-term success.

However, to overcome our own human nature, we have implemented a series of checks and balances. Our quantitative Fundametrics® methodology is designed to keep our emotions from influencing the investment process while the qualitative research review provides a check for reasonableness. This approach helps us to maintain our focus of identifying stocks that exhibit both attractive valuations and prospects for future growth.