The Centurion Counselor

Second Quarter 2007

UNDERVALUED SECTORS
(CONSIDER!)
- MEDIA
- CONSUMER DEFENSIVE
- MEDICAL DEVICES
- MEDICAL DIAGNOSTICS

OVERVALUED SECTORS
(AVOID!)
- JUNK BONDS
- EMERGING MARKETS
- MONEY CENTER BANKS
- REITS

Paying the Pied Piper

In past issues of The Counselor we have talked about the coming slump in real estate (Q2 2004), the subprime loan mess (Q1 2007), excess risk in the market place and the potential for problems in the use of derivatives (Q3 2006). In the second quarter they all started to come together.

In typical 'closing of the doors after the cows are out of the barn fashion', Congress will no doubt make it harder for the subprime borrower to actually get a loan. This, in turn, will make it harder for those starting out to purchase their first home. Which, in turn, will decrease demand and cause home prices to drop further, which will cause more loans to go bad. This is a developing scandal every bit as big as the Savings and Loan scandals of what seems like another era. In those old days, the Savings and Loans were forced to dump foreclosed properties on the market, causing the prices of real estate to drop. This caused more loans to go bad, then the Government came to the rescue and took over the Savings and Loans. The first thing they did was to sell all of the properties owned by the "rescued" Savings and Loans and as a result, property prices then plummeted. Further, we believe the same 'snowball' effect could be happening today in the subprime industry. According to the Bloomberg news service, "Bear Stearns and its affiliates are listed as buyers (through foreclosures) of at least 53 homes so far this year in San Diego County, California, 48 in Maricopa County, Arizona, and 40 in Cuyahoga County, Ohio, according to a search of property records. JPMorgan, the third-largest US bank, and its subsidiary Chase Home Lending, acquired at least 194 homes this year through foreclosures in Wayne County, Michigan. Merrill, the third-biggest securities firm by market value, and its mortgage unit, First Franklin, took possession of at least 87 homes this year in San Diego County, California. Citigroup and affiliates are the new owners of at least 47 homes in Clark County, Nevada."

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Paying the Pied Piper (continued)

Just last week, the rating agencies downgraded $17 billion of subprime bonds. Many institutions are not allowed to hold bonds that are less than investment grade. This will force more bonds on the market, which will lower the price of bonds, which will force more holders to sell. Due to falling house prices, lenders will be anxious to foreclose as quickly as possible to avoid further price erosion. Subprime loans made at the end of 2006 were defaulting in only one or two months from the date of the loan. No-documentation "liar's" loans were common. Adjustable Rate Mortgage (ARM) loans, made where the applicant could clearly not make the payments when the interest rate reset, were common. As a result, we do not think the drop in single-family home prices in many areas of the country is over and we also believe that more shoes will drop as hedge funds are forced to realize losses in their subprime portfolios.

This is where the rating agencies come in for their share of the blame. Let's look at the rating agencies. Moody's, Fitch, and Standard and Poor (S&P) all are in the rating business. If you have a bond offering and want to sell it into the institutional market, they assess the ability of the borrower to pay the note and assign a risk level or rating, the highest typically being AAA. There are only a handful of corporations which can get an AAA level for their bonds.

According to John Maudlin, "when a corporation gets a rating, there are audits, not to mention regulators that are there overlooking the data upon which the ratings are based. But no one was looking at the data used to create the ratings on Residential Mortgage Backed Securities (RMBS) and Collateralized Debt Obligations (CDO), to make sure there was some type of reasonable similarity or standard of the securities being rated and the databases used to do the risk analysis. Subprime loans made in 1999 or 2002 were significantly unlike those made in 2004-2006. So, the rating process was not the same as the ratings that were used in the corporate world. But the problem is that the ratings used the same designations. Instead of creating a whole new type of rating standard (say, using numbers like "CDO rank 1-10"), they used the same designations that bond investors were used to.

Paying the Pied Piper (continued)

I think it is disingenuous for a rating agency to explain the difference in paragraphs 457-503 in 7-point type and dense legalese in their disclosure document. Investors had (and should have) a certain level of expectation when the designation "AAA" is used. GE and EXXON types of expectations".

When you pool BBB tranches into a CDO and now turn 80% plus into AAA at the touch of an algorithm, based on faulty assumptions, someone somewhere should have raised an eyebrow. How much is the exposure if they have to mark (to market) their CDOs and subprime holdings? Who knows? The answer is no one knows, yet.

The important thing to keep in mind is the tendency of investors to project their recent experiences into the future. This tendency might be the explanation behind the large increase in the velocity of money and one of the explanations behind the markets' ability to make multi year highs in the face of tightening primary liquidity, high oil, weak Dollar and the subprime mess.

This is something about which we have written at length. It is part of the human psyche and one of the main reasons that analysts and investors are so wrong in their predictions. It is why we have runaway bull markets, and every now and then, bubble markets. We move the price of an asset class until it is priced for perfection. Then along comes disappointment and the bull stumbles or the bubble is burst.

As Nobel Laureate Hyman Minksy points out, stability leads to instability. The more comfortable we get with a given condition or trend, the longer it will persist and then, when the trend fails, the more dramatic the correction. The problem with long-term macroeconomic stability is that it tends to produce unstable financial arrangements. If we believe that tomorrow and next year will be the same as last week and last year, we are more willing to add debt or postpone savings for current consumption.

Paying the Pied Piper (continued)

Thus, says Minsky, the longer the period of stability, the higher the potential risk for even greater instability when market participants must change their behavior.

One thing we all know about return is that asset classes have a risk premium. They will pay you a return relative to the amount of risk the 'market' deems you to be taking by owning a particular asset. The risk of a Treasury Bill is less than the risk of a small cap stock and so is the return over time. There was a saying in the seventies among commodity traders: "Watch out for the risk, and the returns will take care of themselves." Today, returns do not seem to be taking care of themselves, and going forward, it may be that investors have to actively seek riskier assets or structures to earn a respectable risk premium.

We believe that the nature of risk in the markets has changed. It could be higher or lower, but it's different. The cumulative impact of technology, telecommunications and financial product innovation has altered the way information is shared, orders are transmitted, and both risk and return factors are dispersed. The proliferation of derivatives has created leverage never imagined a generation ago, let alone five years ago. Trillion dollar exposures now exist in instruments that make the '90s seem like a different century. Ok, it was a different century. Empirical data supports the conclusion that market risk is changing but we firmly believe that no return is risk free and the apparent free lunch enjoyed by some subprime borrowers, 30-something hedge fund traders, mortgage lenders, investment banks and housing speculators is over. We fear it will get ugly before it gets better, but every bubble, when popped, creates tremendous opportunity and this one will be no different.

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