



# The Centurion Counselor

Third Quarter 2007

## UNDERVALUED SECTORS (CONSIDER!)

- OIL SERVICES
- CONSUMER DEFENSIVE
- MEDICAL DEVICES
- MEDICAL DIAGNOSTICS

## OVERVALUED SECTORS (AVOID!)

- JUNK BONDS
- CHINESE MARKETS
- MONEY CENTER BANKS
- REITS

## Who is to Blame?

In prior issues, we have discussed the effect of the Fed keeping rates too low too long. Almost all asset classes enjoyed a bull market. Commodities, real estate, gold, oil, equities, etc. all rallied strongly.

Quality bonds, for the most part, sat out the boom. Ultra-low rates have a positively dreadful effect on those institutions that rely upon fixed income products to meet their funding and inflation-hedging needs. These include insurance companies, banks, private and public pension plans, trusts, and endowments.

With rates so low, they began to feel the temptation to "reach" for yield. Some just a little bit; others with reckless abandon. Thus, another investing rule was ignored: Few things in life are as expensive as the reach for yield. Individual investors who do this are called *yield pigs*.

There are very few ways to obtain significantly more yield without taking on considerably more risk. Over the past few years, a variety of techniques were employed: some managers crept further and further down the quality scale in exchange for higher yields. Some took on just a little more risk, hoping no one would really notice. Others borrowed money in low-rate nations (like Japan) and invested it in higher rate countries (aka "the carry trade"). Some used leverage, although that has a variety of inherent problems. Some clever folks tried complexity, which hides the additional risk you are taking on from the view of most observers.

One particular group of folks checked the box marked "ALL of the above": certain types of (but not all) hedge funds. Aggressive fund managers borrowed lots and lots of money from their prime brokers, suitably leveraged up, went out, and bought into the alphabet soup we discussed; or used the leverage to do a lot of supposedly low volatility trading. Bear Stearns and Goldman Sachs were among the victims of this trade.

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## Who is to Blame? (cont.)

Under normal circumstances, that might not matter much. However, these were not normal circumstances. Over the past five years, we have had an enormous credit bubble. The normally staid banking industry was seduced by the monstrous demand for high yielding mortgages to get collateralized into all of these instruments. Farmers know the expression *Make hay while the sun is shining*. Bankers saw the nearly unquenchable demand for mortgages, and they knew it was time to "make hay". They replaced the old method of approving mortgages (i.e., a human looking over a loan document) with an automated software program. This was a key technological development that allowed them to crank up the machinery to underwrite lots and lots of loans. Some good, some bad, some really ugly. In the new mortgage math, it was true that  $1+1=3$ .

In this headlong rush, lots of foolish shortcuts were taken. Loans were written to people with low FICO scores and on properties with very high loan to value (LTV). Documentation was often poorly filled out. An entire new category was created: "no doc" (no documentation needed) loans. Today, we know these products as "liar loans," thanks to the commission-driven mortgage brokers who encouraged borrowers to "get creative" when filling out the no doc applications.

Then there are the 2/28 loans. These were primarily offered to subprime borrowers—those with weak FICO scores, or modest incomes. These loans typically start at a fixed "teaser" rate for two years, before resetting 300 or so basis points higher to a variable rate. Disproportionately, these reset mortgages are the ones that have been going into default and foreclosure at alarming rates. And that has caused a cascade reaction all the way through the entire financial system.

Low rates drove the initial demand for mortgages; technology allowed for rapid processing in numbers never before possible; securitization drove the demand for bundled mortgage purchases; speculative fever drove housing prices higher and kept even poor credit risks from defaulting for a few years. These factors are what led to a huge spike in real estate sales from 2002-2006. As in the equity market bubble in 1999, a bull market was confused with genius. When the history of this era gets written, what we know as the housing boom will likely be reconsidered as a giant credit bubble.

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## Who is to Blame? (cont.)

### Who was Responsible?

The responsibility is widespread, with plenty of blame to spare. We assess the responsibility for the mess to the following:

- Federal Reserve (FOMC)
- Borrowers
- Mortgage brokers
- Appraisers
- Federal Government
- Fannie Mae
- Lending banks
- Wall Street firms
- CDO Managers
- Credit agencies
- Hedge funds
- Institutional Investors (pensions, insurance firms, banks, etc.)

### Let's Look at Each of These:

All interest-related issues begin and end with the Fed. As we have noted before, the FOMC cut rates extraordinarily low, and then kept them there for far too long.)

Regardless of how low rates are, the simple fact remains that many **Borrowers** recklessly took out mortgages regardless of their ability to pay the monthly carrying charges. This was simply reckless behavior, and should be appropriately recognized as such. This makes me feel foolish for having taken out a mortgage I could actually afford. Had I suspected that a bailout of reckless behavior was forth coming, I would have taken out a \$10 million mortgage and gotten a much nicer house.

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## Who is to Blame? (cont.)

### Who was Responsible? (cont.)

Next up in our cavalcade of criticism: The **Mortgage Brokers**. This is a lightly regulated industry, ripe for lots of abuse. It seems that every day trader in 1999 became a mortgage broker in 2006.

Then there were the **Appraisers**. In the real estate boom of the 1980s, the professional designation for appraisers MAI jokingly became known as *made as instructed*. There were drive-by appraisals, with mortgage brokers, steering appraisal business to those appraisers known to give generous estimates. As a result, this business rose rapidly.

It's not like the **Federal Government** was unaware of the problem. In 2005, more than 8,000 appraisers—roughly 10 percent of the industry signed a petition asking the federal government to take action. No regulation to prevent this rampant fraud was ever created.

Next on the list was **Fannie Mae**. One might have thought the firm that had been in the business of securitizing mortgages since 1938 would have some insight into what was actually going on in the mortgage markets. No such luck. Perhaps Fannie Mae was otherwise occupied untangling its own massive scandal: An "extensive financial fraud" had occurred with earnings doctored so that executives could collect hundreds of millions of dollars in bonuses.

The **Banks** that underwrote these loans also get some blame. The automation they installed permitted rapid processing of bad credit risks, but it was the outstanding sloppiness and violation of the banks' own internal procedures that allowed even more bad loans to get written. Hard as this may be to imagine, some loan documentation was so incomplete that the federally mandated "Truth-in-Lending Disclosures" were omitted. Without the proper disclosures, a mortgage could become "unsecured" meaning it no longer has a first priority lien on the mortgaged property.

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## Who is to Blame? (cont.)

### Who was Responsible? (cont.)

How did **Wall Street** manage to overlook all of these issues? Did they actually do their due diligence? Or, was it simply a case of keeping the securitization process rolling? It appears that as long as deal fees could be generated, Wall Street kept the CDO factories running.

Then there were the **Credit Agencies**. Far from being objective arbiters of the credit worthiness of these debt instruments, the three major agencies-Standard & Poors, Moody's, and Fitch Ratings-conducted a form of "pay for play." Working closely with underwriters, they frequently rated paper AA and AAA that would (and will) eventually be revealed as junk. They were tremendous, well compensated enablers of the entire sub-prime fiasco.

Of course, none of this would really have mattered if a few hedge funds and a much larger number of institutional investors had not sucked up so much of this suspect paper. Entities including foreign central banks as well as China evidently bought \$10 billion in subprime mortgages. Through the indiscriminate use of leverage, and by failing to know what they owned, the hedge funds must shoulder some of the blame. Just this week UBS and Citicorp took big hits to their earnings.

And to be fair, the institutional investors bought the paper from Wall Street firms who touted the AAA ratings of the paper. Their lawyers will certainly portray them as the victims when they get to court.

Finally, we come back to the Federal Reserve-only this time; it is not the rate setting FOMC that gets the blame. Rather, it's the Central Bank's regulatory authority that gets the blame for sleeping throughout this entire episode. But not to worry: On August 14, 2007, the Central Bank proposed that "consumers have clear, balanced, and timely information about the relative benefits and risks of certain ARM products." Talk about locking the barn door after the horses have gotten out.

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## Who is to Blame? (cont.)

The highly leveraged speculation in mortgage-based securities cascaded across the globe. The aggregate foreclosures of bad mortgages led to a near seizure of credit markets. These markets are so essential to the smooth operation of the global economy that central bankers around the world had to react by injecting massive amounts of liquidity into financial networks. They have managed to stabilize skittish markets and restore investor confidence, for now.

### Will it Spread to Commercial Real Estate?

We believe that it will but at a much slower pace than we are seeing in residential real estate. Of course, we have the commercial touts saying that it is different this time, but that is what they always say. They point out that commercial delinquency rates are approximately 1%.

What they fail to take into account is that the cost of mortgage money has increased over 100 basis points even as the Fed cut rates. The higher cost of money reduces the return a buyer can expect from a property. Unlike residential loans that typically have a 30 year term, commercial loans have a balloon payment in five or ten years from the date the loan was made. In addition, a significant amount of the monies that went into commercial properties in the past five years have come from Tenant-In-Common (TIC) transactions. These are 1031 tax-deferred exchanges. In the prior five years, over \$13 billion of new monies have gone into TICs. The bulk of this money has come from the run-up of value in residential properties. Now the game is up; we believe that the engine that has been driving commercial properties is out of gas. Easy mortgage money was the mother's milk of real estate appreciation; now, without gas and milk, we believe the game is near an end. It will unwind at a slower pace than the subprime debacle did, but it will last much longer. The last commercial real estate slowdown lasted almost ten years. It was not straight down, and it had some good rallies during that time. We believe that the coming slowdown and correction will last three to five years.

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