

August 20, 2007

## **Reflections on the Sub-Prime Mortgage Mess**

We thought we'd take a moment to offer some perspective on the turmoil in the sub-prime mortgage market and provide some assurance regarding your exposure to it.

Fundamentally, what's happening is that lenders who made bad loans are being punished. We think that is a good thing, but the process of purging this activity is going to provide financial drama for a little while and presents one more challenge to an otherwise reasonably healthy economy.

### **First, a brief tutorial on sub-prime loans.**

Sub-prime mortgage loans are made to borrowers with poor credit histories, often without down payments, at low, temporary "teaser" interest rates or without proving their incomes or assets. The loans are repackaged into pools, which are resold in pieces that come with varying risks and yields. Defaults on such loans have spiked due to the housing slowdown and the resetting of adjustable-rate mortgages. Consequently, the loan pools and the securities based on them (especially the riskiest pieces) have fallen in value, in some cases so precipitously that the market for them has evaporated.

Institutions (notably hedge funds and foreign financial institutions) that buy these loans, often using borrowed money, have been badly affected. Many have sold portions of their portfolios to meet investor redemptions or to pay margin calls to nervous lenders or simply to reduce their risk. Due to the lack of liquidity in sub-prime debt, such investors have sold from their portfolios better quality bonds or other financial instruments (such as stocks) that remain marketable. Simultaneously, other investors have increased their purchases of U.S. Treasury securities as a safe haven from this crisis. This process is probably still playing out, although to what degree is difficult to say.

### **What does all of this mean for clients?**

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With just this in mind, we took a look at the managers we recommend for the bond portions of client portfolios to see how they are positioned with respect to sub-prime debt. We are pleased with what we found. Of the four managers we typically recommend, all but one of them are "up" since June 20<sup>th</sup> (the date of first identifiable casualties—the closing of two hedge funds

by Bear Stearns). The fourth manager, who is focused on investment grade corporate and sovereign debt, is down very slightly, which is understandable given the increased yields (and lower prices) on investment grade debt brought about by the rally in U.S. Treasury debt. However, this condition is likely temporary and the manager has handily outperformed its benchmark index since the inception of its fund.

In fact, our research on these managers shows that they have been concerned about the credit quality of sub-prime debt and potential de-leveraging of hedge funds for some time and took steps to improve the credit quality of their portfolios in anticipation of a shakeout in the credit markets. This is exactly the type of forward thinking we expect from our managers and appreciate their discipline in following their convictions even at the expense of short-term performance. At the time, PIMCo, which receives our largest allocation, was accused by one investment banker of being “irresponsibly conservative” when they gave up a bit of yield in order to obtain substantially better credit quality.

While the adverse effects of the sub-prime crisis have largely been avoided in the fixed income portion of our model portfolios, you should probably expect declines in stock prices due to the secondary effects on the economy and corporate earnings. These effects may be of at least two kinds: (1) higher borrowing costs could dampen corporate profits and buyout activity; and (2) consumer spending may become further constrained if housing prices fall more steeply due to a greater number of distressed home sales. Also, to the extent the crisis causes a general and sustained reevaluation of lending standards and risk, we may see a general reduction in the leveraging of financial portfolios among institutions. These factors may add up to a modestly depressive effect on stock prices.

On the other hand, these concerns may have already been priced into the market. The S&P 500 Stock Index is down 6.9% from its record high in mid-July. Some market strategists are already calling this a buying opportunity in equities and point to healthy employment figures, booming exports and robust (if more slowly growing) corporate profits. Stocks are not carrying the high price-earnings ratios normally associated with a market top.

Having said all of this, we note that market predictions are notoriously unreliable and the market-timing they sometimes inspire has been repeatedly shown to be harmful to investor portfolios. Clients who are fully invested in the market should view, as we do, this present kerfuffle within the context of a market that provides good long-run returns but whose short-term direction can be overtaken by emotion and events.

### **A Few Remarks on Hedge-Fund Managers and Other Masters of the Universe**

Without slipping into *schadenfreude*, we also observe that hedge funds and other supposed masters of the financial universe have suffered most during the recent turmoil.

Two Bear Stearns funds are bankrupt. Goldman Sachs's flagship fund is down 16% for the year. Harvard University lost \$350 million when a former endowment manager's hedge fund collapsed. These are but a sample. Long-short funds for retail investors, which are similar to hedge funds, have also performed poorly. Most of these "products" are quant-driven, meaning that a computer selects and executes trades.

This carnage reinforces our belief that financial engineering is no substitute for good judgment. While the long-short folks say they profit in both rising and falling markets, they seem to have forgotten that if they short the wrong stocks and buy the wrong stocks they can lose money both ways and their leverage will magnify the loss. And because many hedge fund managers were making the same trades, they acted as a herd when closing positions to meet margin calls and pay redemptions.

Rather than entrust our clients' futures to a computer or an index, we select managers who look for value by rolling up their sleeves and performing fundamental research. In this respect, we regard the market as a garden to be tended, not a casino to be played. After all, the equity market represents the ownership of our capitalist economy and that of the free world. Fundamentally, those economies are productive. By owning portions of them, with sufficient time, investors can earn good returns.

As always, we welcome your comments and questions.