



SUPREME ("SUBPRIME") DEBACLE

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You can't pick up a newspaper or listen to a business news network without hearing the word "subprime" along with the adjectives chaos, meltdown, crisis, etc. What exactly is going on?

The word "subprime" is Wall Street language for mortgage loans to less than credit-worthy clients, often referred to as "Ninja" loans (no income, no job, and no assets). As long as house prices continued to rise everyone was ok. The borrowers were able to refinance their houses every 18 months or so to pay off the unpaid interest on their previous loan. When house prices started to decline and interest rates rise the music stopped. If this were all there is to the story then there would not be a crisis.

Enter Wall Street. To earn fees Wall Street investment banks "packaged" these subprime loans into CDO's (collateralized debt obligations). For example the banks would take, say, \$100 million of mortgages and create a pool. Then they would sell, say, 3 different "tranches" of the pool, not unlike someone buying a house with a first, second and third mortgage. The first tranche of the mortgage pool, say 25% of the value or \$25 million, would often qualify as AAA rated debt. Standard & Poor's and Moody's were paid by the banks to rate the various tranches of the CDO's. The bottom tranche was often referred to as "equity" and carried the highest interest rate.

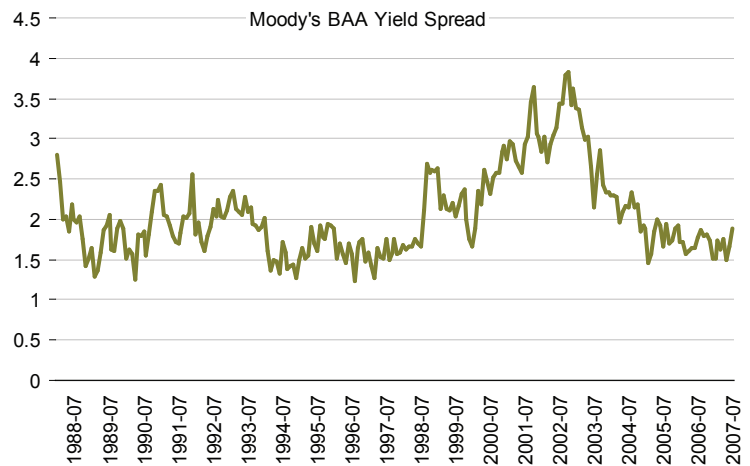
Who were the buyers of the equity tranches? Enter the so-called "hedge funds". The hedge funds not only purchased the most risky of the CDO tranches but they also used leverage, often several times their own investment. Returning to our example of the \$100 million pool of subprime mortgages, the hedge funds that bought the \$25 million equity tranche would probably only have put up, say, \$5 million of their own money. The same "packagers" of the mortgages, the banks, also lent the hedge funds money to buy the CDO's.

The reason that we now have a crisis in the debt markets should be clear. With clever "financial engineering" the mortgage originators were able to offload their Ninja loans to other financial institutions. They in turn sold off the riskiest part of the loan packages to the hedge funds, who in turn borrowed most of their "equity" investment from the same banks. It was simply leverage piled upon leverage.

What happens now? Many of the hedge funds will go under. The same fate has already befallen many mortgage lenders. The difficult issue today is how to put a dollar value on the mortgage pools. If we can't put a number on the mortgages, then of course, the CDO's can't be valued.

Too Close for Comfort

Moody's BAA Spread over Treasuries (%)



And the banks are holding billions of dollars of these CDO's. This is why the world's central banks have had to intervene and buy up these CDO's and thus inject liquidity into the debt markets.

Will the debt crisis brought on by foolish lending practices and too much leverage spread to the rest of the debt markets and ultimately lead to a recession? I think not. The central banks know the risk, the large Wall Street banks are well capitalized and the world economy is growing at better than 5% per year. There will of course be casualties, and credit spreads (the difference between Government debt and more risky debt) will return to normal, although we still have a ways to go (see attached chart). The last 4 years of low rates, rising house prices, and huge amounts of liquidity in the system created artificially low spreads. Well that's over and we are back to reality.



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