



# Supreme Debacle: Phase 2

## Phase 2 Asset Backed Commercial Paper

Authored by: Stephen D. Barlow, MBA, CFA Chairman  
& Portfolio Manager

We discussed last week how the U.S. mortgage subprime debacle was created and who the likely casualties might be. We focused on hedge funds. Little did we know that an obscure investment banking firm in Toronto, Coventree Inc., would turn out to be the epicenter of subprime mortgage woes in Canada.

Coventree is a relative newcomer and specializes in Asset Backed Commercial Paper (ABCP), an asset class most of us had never heard of until this week. Coventree would "package" consumer debts in many forms (e.g. car loans, Canadian Tire credit card debt, mortgages, etc.) and sell money market certificates against this consumer collateral (often referred to as a conduit). Coventree relied upon its ability to roll over these liabilities which were written for periods of 3 – 6 months to as little as 7 days. However, the consumer loans have maturities for much longer periods, as much as five-seven years, and as such Coventree relied upon a smooth functioning money market and low default risk ratings from DBRS (Dominion Bond Rating Service) to maintain its liquidity. A week ago in response to the U.S. subprime crisis, Coventree elected to send a note to its institutional customers suggesting its exposure to the U.S. subprime market was a mere 7%! That admission set off alarm bells, and the Canadian Commercial Paper market was in a state of panic. The amount of exposure that retail investors in Canada have to the third-party Asset Backed Commercial Paper market is huge, perhaps \$40 billion. It relies on confidence. Huge amounts of money are lent for very short periods of time with the expectation of repayment on maturity. When the spectre of non-payment looms everyone heads for the exit at the same time. The result is a classic liquidity squeeze. And in Coventree's case by "lending long and borrowing short" it succumbed very early.

How did this happen and how did Coventree grow so quickly? The big five Canadian banks dominate the Commercial Paper market. The Caisse de Depot and other Quebec institutions wanted to create an alternative and were instrumental in creating the Asset Backed Commercial Paper market. The Caisse is a significant owner of Coventree. So when Coventree got into trouble the big five Canadian banks said it wasn't their problem. Why should they bail out a competitor? The Caisse and several European banks have been trying to get a package together to bail out Coventree and others. Their solution is to try and create a new "asset" that will better reflect the maturity schedule of the pledged assets with a floating rate of interest. It may work but for those money market funds knee deep in ABCP it's a huge problem.

Most aren't allowed to own Commercial Paper maturing in more than one year. The funds may be forced to sell at a loss and hence investors in these funds may be in for a nasty surprise. Perhaps the Canadian bank most at risk was the National Bank which would go along way to explain why it chose to repurchase about \$2 billion in troubled Asset Backed Commercial Paper from its retail mutual funds and like investments. They along with the Caisse were strong supporters of the ABCP market. It's almost like the old days of Montreal versus Toronto in hockey and finance.

The loss of confidence in any market is critical. The ABCP market is huge. The repercussions will be felt for some time to come. Everyone's appetite for risk will be muted. This is the dreaded "contagion" that everyone fears. The most immediate indirect victims will be the small cap or venture firms. Their access to capital may be restricted. In the rush for liquidity investors are marking down the value of small caps indiscriminately. Gaps of 30 – 40% in the bid/ask of a security are not uncommon. I suspect mutual fund redemptions may be part of the explanation for the sell-off.

What are the strategic options for investors in this market? The large cap liquid names that make up the TSX 60 index will be the market leaders. For the small cap area there is no better time to invest if you have done your homework and have the patience to wait 6 – 18 months. Buy companies with real assets (especially in Western Canada), no significant debt, and good earnings visibility. You will be handsomely rewarded. One sector to avoid is the leveraged natural gas producers who need financing to continue operations.

A caveat. If you own any money market funds that have grown exponentially in the past two years, you should talk to your advisor. As new funds entered the market in 2005/2006 they offered a premium interest rate to attract new investors. Prior to the current crisis, spreads were very narrow. The only way these new entrants could earn a positive spread was to invest in exotic instruments like subprime mortgages and ABCP. They may be stuck with some pretty toxic paper in their portfolios.



**TrueBalance™**