

Market Commentary

A Crazy Quarter

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What happened?

The stock market moved higher in July. The Dow briefly reached 14,000. Private equity buyouts continued to propel the stock market higher. There were, however, more than a few signs of excessive Private Equity speculation. Signs of problems in the sub prime mortgage sector started to become more evident in late June with the collapse of several large hedge funds. Initially stock investors seemed to shake off these worries.

As July progressed it became increasingly clear that the sub prime problems were more widespread than most people thought. More financial institutions reported exposure and potential write-offs due to these mortgages. The euphoria of early July turned to panic as credit markets seized up and the Dow dropped dramatically from about 14,000 to below 13,000. With concerns mounting about the impact on the economy, the Federal Reserve took the unusual step of cutting the little used and largely symbolic discount rate. This caused the stock market to immediately begin to rebound and was followed by a somewhat unexpectedly large cut in the Federal Funds rate of one half percent on September 18. When that was announced the stock market soared more than 300 points.

The net of all of the volatility was a pretty good quarter for the stock market. However all is not, in our view, sweetness and light and problems remain.

Why did it happen?

The why behind the volatility is really the story of a new financial era. In the “old days” (say 20 years ago), banks and savings and loans made mortgages in conservative ratio to documented property value to borrowers who could document their ability to repay. They either held them on their own balance sheets and lived with the consequences, or sold the smaller ones to large institutions like Fannie Mae.

In the new financial era mortgages are packaged, sold and resold on Wall Street. They are sliced and diced into other securities (collateralized mortgage obligations and collateralized debt obligations, to name two of the most prominent). Instead of

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just ending up on the balance sheet of a bank or Fannie Mae, they now end up either directly or indirectly owned by pension funds, money market funds, mutual funds and hedge funds. In the case of hedge funds, the new security is often then juiced up with borrowed money which enables the fund to own securities whose value far exceeds the fund's equity. Leverage is great when things are good and it is disastrous when things aren't. That's what happened in this case. As concern about sub prime exposure mounted, the market value of these new securities fell. This created liquidity problems for the owners who had purchased them using borrowed money. That turned into a panic in which investors imagined sub prime mortgages everywhere and financial institutions didn't want to make loans against collateral with uncertain value. It took a very large dose of Fed induced liquidity to calm the markets and encourage those with capital to again start making loans.

This is a very simplified version of what took place, but it's indicative of what can and might happen again in the new financial era.

What's next?

At the end of June we had concerns about the level of the stock market. Those concerns increased as the market went up in early July. Some type of correction seemed to be in order, although the volatility which accompanied it was certainly unexpected. While it's nice to see the market rebound, we don't think the last of this story has been written. We don't think stocks overall are overvalued. However there are speculative excesses in the market, which are cause for concern and caution. We would not be sellers of stocks, but we are very cautious buyers. The main lesson from the third quarter is not to be too giddy in good markets, or too depressed in bad ones. Long term investors were not hurt by the market volatility and that long term outlook remains the best approach for most people.

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