

Market Commentary

Contrarian Call?

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The major story of 2007 was the meltdown of financial markets due to problems relating to subprime mortgages. Nothing dominated investors' concerns more than the impact on the economy of rising mortgage defaults resulting in write-offs of billions of dollars by major financial institutions.

As the year ended, doomsayers were predicting more write-offs and a prolonged period until financial giants regain their footing. We want to make an argument that such predictions could be more than slightly off the mark. It's important to separate the facts from journalist fiction of the current situation.

First, subprime mortgages constitute about 15% of the mortgage market in the United States. According to one report about 80% of the subprime borrowers are current in their payments. Another said that about 3.3% of borrowers are more than 30 days behind in their payments. It is true that foreclosures are up substantially, real estate prices have dropped and there is a record supply of new houses on the market. There are clearly borrowers and lenders who have been hurt by over exuberant borrowing and lending. However based on these statistics more than 95% of mortgages are current.

Second, the investments being written down by financial institutions are not mortgages themselves, but rather are hard to value securities based on mortgages. This is an extremely important distinction. Many of these securities are not directly backed by mortgages, but rather include a variety of assets and derivative contracts whose value is tied in some way to mortgages. Because of the leverage inherent in the way these securities are structured, the impact of the relatively small number of mortgage defaults discussed above is magnified in the derivative securities.

Third, the securities being written down are extremely hard to value. In a liquid, functional market in which there are many potential buyers this wasn't a big problem. However in a market dominated by fear, it has become a very big problem. Generally Accepted Accounting Principles require financial institutions to value securities on their balance sheets based on what they reasonably think those securities are worth in the open market on the date of the balance sheet. In a market such as this in which buyers are few and wary of the underlying collateral on these securities, prices drop and this forces the financial institutions to write them

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down to a level which they can justify to investors and regulators. One extremely respected regulator apparently remarked about the value of Collateralized Debt Obligations: "I'd like to know what the damn things are worth."

What then should an investor do? It's our position that there has been a significant overreaction in the stock prices of many (but not all) major financial institutions. On what do we base this proposition?

First, there is the general tendency of investors to overreact to both good and bad news. Excessive optimism is usually followed by excessive pessimism. In addition, the path of least resistance is frequently to do what others are doing. It's less risky to be part of the thundering herd where if one is wrong, you've got lots of company.

Second, major financial institutions are much more highly regulated and better capitalized today than they were the last time they faced a crisis of this sort in the early 1990's. Many of the biggest financial institutions have very well diversified lines of business which can compensate for problems in one or more markets.

Finally, we are starting to see some major players put money into some of the distressed financial institutions. Just in the last month there were multi-billion dollar investments by sovereign wealth funds in three major financial institutions whose stocks have been beaten down in the current market turmoil. A number of other hedge fund and financial institutions are making major investments in distressed mortgages. These people could be wrong, but many of them have very good records for spotting opportunities where others see problems.

This has been a difficult year to be a large cap value manager. The stocks of large dividend paying financial institutions have long been an integral part of that investment approach, and watching them decline has certainly been painful. However, we see some significant opportunities in the current distressed market.

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