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Written by: Philip C Benedict, CFP®
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BENEDICT FROM THE 5TH FLOOR

6000 Lake Forrest Drive NW, Suite 550, Atlanta, GA 30328-5901 • 770 671 8228 • 770 671 0232 *fax* • 800 678 8227

THOSE PESKY BLACK BAGS!

The big brokerage firms of Wall Street are what the industry calls INVESTMENT BANKERS. This means they *manufacture* investment products. Their primary purpose in life is to raise capital (money) for global corporations and governments. Let's say you are a big company and need money for expansion. It's the INVESTMENT BANKERS who will help you issue bonds (borrowings) and they will "package" them in a form that will appeal to the buying public.

Prior to the 1970's, these big INVESTMENT BANKERS were private partnerships. Thus, if they took a big risk and lost, they lost their own money. Then, in the 1970's most of them became public companies. Now, if they take a big risk and make a lot of money, they all get big bonuses. If that big risk results in a big loss…it is shareholder's money and not theirs.

Firms that are Registered Investment Advisors by law must put the client's interest first. The brokerage firms do not have this requirement… a BIG difference. That doesn't mean they aren't heavily regulated, but they do represent the "seller" so to speak.

The INVESTMENT BANKERS spotted opportunity in the sub-prime mortgage industry. "What if we take some good mortgages and slip some sub-prime mortgages in one package, who would notice? And, if they do, we can assure them that some of those sub-prime mortgages will turn out good. Besides, mortgages last thirty years, who will be around then to complain?" Now, picture a black plastic bag in which the BANKERS toss in one hundred different mortgages. They will call this a Mortgage Backed Security or Mortgage Bond.

Brilliant idea, but then Wall Street is always full of brilliant ideas. But, they had to get the rating agencies on their side. They go to the agencies and ask "what will it take to get a AAA rating for a bag of mortgages?" The rating agencies said something like, "you follow our recipe and pay us a fee and you will get the AAA rating." Let's say that recipe was ninety good mortgages with ten sub-prime mortgages mixed in.

Perfect, toss ten sub-prime mortgages in the bag and ninety good mortgages and you now have a AAA rated Mortgage Bond, that pays a higher interest rate than regular government bonds. The BANKERS figures they could sell these all day.

But, even with the AAA rating some of the buyers were a little cautious. What does a creative BANKER do?...get a guarantee. He takes the black plastic bag across the street to AIG, the biggest insurance company in the world, and, for a fee, they agreed to guarantee the bond is good. Now our BANKER really has a product he can sell. When the BANKER left AIG the executives probably laughed and looked at each other. "Why, that guy just paid us a fee for guaranteeing a bond that was already rated AAA and is backed by residential mortgages. There is no way we can lose. We will guarantee all of those he can bring us."

However, there were some things that the insurance executives may not have considered at the time:

- U.S. residential real estate was in an inflationary bubble like we have never seen before.
- Even the "good mortgages" had terms that were very different from traditional mortgages...interest only, adjustable rates, payments optional, etc.
- But, maybe the biggest hole in the black plastic bag caper was that when a mortgage is new, you don't know if it will be a good mortgage or a bad mortgage. In other words the BANKERS had no idea whether they were following the "recipe" or not and neither did anyone else.

Let's see how our black plastic bags may have impacted banks. By law, a bank must have so much "capital" in relation to the amount of loans. Let's say that is ten percent. Thus, if the bank has $1,000 of capital it can make $10,000 of loans. So, our bank goes to the INVESTMENT BANKER and purchases one of his black plastic bags with his $1,000…he's got his capital…AAA and guaranteed. However, if later it turns out that the black plastic bag is not worth the $1,000, then he has to come up with more "capital."

Some information from the past

In the late 1970's Congress created the Community Reinvestment Act (CRA), a well-intended law to encourage minorities to gain home ownership. Not much happened until the mid-nineties when rather radical "housing rights" groups lobbied for the law to be aggressively interpreted and, literally, forced banks to make loans to people they knew could not, or would not, honor their obligations. The revisions allowed for these sub-prime loans to be packaged together and sold as Mortgage Bonds. Fannie Mae and Freddie Mac agreed to buy some of the loans or at least guarantee them.

So, everyone won! The mortgage company got to write a very profitable loan to someone who didn't deserve it and sell it to an INVESTMENT BANKER who would take his profit and turn around to sell it to someone else. Every one was doing just what the Regulators wanted them to do…help people buy homes who could not afford to pay for them.

Everyone won until everyone lost, including the people who purchased the homes they could not afford.

The great guarantor

Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) should have been the world's most supervised and regulated businesses. There was a special governmental office that had no purpose other than to provide the supervision…the Office of Federal Housing Enterprise Oversight. The office seemed to have plenty of staff, 236 well-paid government workers. What it didn't have was authority. What it did have was plenty of political intervention.

The really big problems with Fannie and Freddie started in the late nineties when Franklin Raines became the CEO. This was a rags-to-riches story if there ever was one…from son of a janitor to Harvard to CEO of one of the largest corporations in the country. However, the high executive compensation skyrocketed and political contributions grew dramatically and in 2004 he was ousted due to serious accounting irregularities. You can read about this in detail with any simple web-search.

Under CEO Raines, in 2003 Fannie created the "no documentation loan," in which the borrower could apply for a loan and whatever he/she put on the application would be treated as the truth with no proof (documentation) required. These were generally called "liar loans" in the industry - when it turned out that some of the information on the applications was not totally correct.

SUMMARY

Who are the winners in this chain of events?
There don't seem to be many. Maybe the mortgage salesman who made a commission on a loan that should never have been written. But, I don't think he feels like a winner as he has spent the commission long ago and now has no job. The same with the mortgage bond salesman at the Wall Street firm who made a lot of commissions. But, he also has spent the money and is unemployed.

Maybe winners will be the members of Congress who, on camera in front of the nation, get to sternly lecture corporate executives about their values and their loose control over money. I can see Senator Kennedy peering over the tops of his glasses as I write.

I imagine the only real winners will be the class-action law firms in New York.

Who are the losers?
Literally, everyone is a loser in this game. The government is involved in things it shouldn't be in. Employees have lost their jobs and probably most of their retirement savings. Landlords lost tenants…the list goes on.

What can we do to prevent this again in the future?
It always amazes me that, when you have a big accident, everyone then wants to do something to prevent it from happening again. I doubt this will ever happen again, even if we do nothing. But, that won't happen: we always pass a bunch of new regulations assuring us that the next catastrophe will be different, but will happen.

What may history say about this era?
I believe we have probably witnessed the end of the Wall Street INVESTMENT BANKS as we have known them for the last thirty years. They won't disappear completely, but American's attention is going to move from Wall Street back to Main Street, from Harvard educated lawyers and MBAs to entrepreneurs and workers. I think you will find the new American focus much more substantive and comfortable. Remember the bad and enjoy the new.

QUESTIONS

Question: I hear people saying that the bail-out of Fannie Mae helped the Chinese government and not the homeowners. What do you think?

Response: I don' t know if the bail-out was perfect, but I do believe we all want our government to honor our obligations. The agency should never have been allowed to get into the mess it became, but I don't want to default on our promises. Actually, if the homeowners didn't default on their promises we wouldn't have this mess, besides Fannie Mae bonds were owned by individuals, pension plans and other retirement accounts, not just foreign governments.

Question: Don't you think we need a lot more regulation?

Response: I'm rather cynical about this as I think it was rules, regulations and politics that are at the heart of the mess. We created a big regulation in the nineties called mark-to-market. Simply, it means that on a daily basis, the BANKS have to mark all their bonds to the prevailing market price. This works in normal times, but, in a panic like we had the last few weeks, it doesn't because there is no market, thus the price has to be literally zero. In other words, those black bags of mortgages that may contain ninety, seventy or sixty good mortgages get valued at almost zero during a panic. This rule greatly compounded the problems we have just witnessed.

Question: Where is the money going to come from to bail out all these big companies?

Response: I think there is a relatively high likelihood that the government will get paid back on the loans to "bail-out" Bear Stearns and AIG. Fannie and Freddie could become profitable but only IF they are converted to non-governmental organizations and free of political interference. I don't see that as likely in today's political environment, thus the taxpayer will provide the funds.

Question: How can you stay so calm when we are in the biggest crisis ever?

Response: I learned long ago that the current crisis is always the worse ever. And, I can't remember how many times I have witnessed the end of life as we know it since I have been sitting in this chair.

Question: Aren't you just being a naïve optimist?

Response: Maybe, but I would rather call it an experienced optimist.

Question: How can you make investment decisions in this type of crisis?

Response: Investing anywhere near the bottom of a market cycle is easy...investing near the top is hard.

Let me explain further. Because of the declines we can now acquire one of the world's premier industrial companies for about ten times earnings and a yield of five percent annually. And, the dividend grows almost every year. We can acquire the world's largest cell phone manufacturer for about eight times earnings and the entire market value of the company is less than one year's revenues. And it pays a growing dividend that is about the same as a ten year treasury bond. The list goes on...as I said - - investing near the bottom is easy!

Create a social program and try to mix it with capitalism...and you create a mess!

PHIL

OUR OFFICE

Philip C Benedict, CFP®
Travis M James
Mark A Beaver
Ashley A Thompson
Jean B Wilson

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The primary author of From the 5th Floor is Philip C. Benedict, CFP®, an Investment Advisor Representative and Registered Principal with **LPL Financial**, a registered investment advisory firm and member of FINRA/SIPC. Travis James, Mark Beaver and Ashley Thompson provide technical assistance. Jean Wilson handles the layout and editing of the newsletter.

BENEDICT
FINANCIAL ADVISORS, INC

6000 Lake Forrest Drive, Suite 550
Atlanta, GA 30328-5901
770.671.8228

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