

INVESTMENT UPDATE

The military calls it “mission creep”—the tendency for a unit to go beyond its original task, overstepping its responsibilities, and, in so doing, losing perspective, getting in over their heads and necessitating a subsequent rescue plan.

This is precisely what happened to the Federal Home Loan Mortgage Corporation (“Freddie Mac”) and the Federal National Mortgage Association (“Fannie Mae”) in recent years. They expanded their operations well beyond what they were created to do and, in a tragic yet predictable fashion, blew themselves up.

You may recall that these Agencies were formed (Fannie in 1938, as part of Roosevelt’s New Deal, Freddie in 1970 in order to provide competition for Fannie) to create a secondary market for home mortgages. Their primary responsibility was to buy mortgage loans from banks, savings and loans, and other mortgage originators, and bundle these loans into bonds. These pass-through securities (so-named because the borrowers’ monthly principal and interest payments were passed through to the bondholder) were made up of loans that conformed to Freddie and Fannie’s standards for loan size, borrowers’ financial health, and documentation.

Having a ready buyer for conforming loans meant that banks and savings institutions didn’t have to keep these mortgages on their balance sheets—they could have one of these government-sponsored enterprises (GSEs) buy the raw loans from them. Then, if the originator wanted to have mortgage loans on their books, they could buy pass-through securities with the coupon and maturity (typically, either 30- or 15-year loans), packaged with many other like loans. These pass-throughs were diversified by originator, borrower and geography, and, best of all, were backed by a “moral obligation” of the US Government. Yes, the pass-through gave up some of the yield of the raw loans, but the marketability and backing of the Government made up for that. This marketability of pass-throughs was particularly valued by S&Ls in the 1980’s when they needed to make substantial changes to their balance sheets due to interest rate swings and disintermediation in their deposits. Of course, pass-throughs were popular among other institutional investors as well.

Another important point to consider is that Fannie and Freddie’s Government *imprimatur* reduced their cost of capital, as they were able to borrow money by issuing

debentures (unsecured bonds) at low rates. Along with the fees generated from servicing the mortgages they packaged, their business model was solidly profitable.

But Fannie and Freddie weren’t the FBI, the IRS, or any other typical US Federal Agency; they were shareholder-owned, like any publicly-traded company. It’s hard to say which came first—a more aggressive business strategy or a more aggressive investor base—but one thing’s for sure: By the 1990’s, these companies tossed out the idea of being “solidly profitable” in favor of keeping “hot money” shareholders happy with a high-growth, freewheeling strategy. And that, friends, is where things went wrong.

This aggressive business model took two dangerous forms. First, Fannie and Freddie began to ratchet up the risk profile of their investment portfolio. This was, from their standpoint, a no-brainer. They could borrow money by issuing debentures at rates only slightly higher than those on Treasury bonds, and invest the proceeds in all manner of securities, including complex derivative instruments and securities backed by low-quality collateral (e.g., subprime mortgages). The second step was to issue securities backed by non-conforming loans, but with the traditional FNMA/FHLMC guarantee of timely principal and interest payments.

As with all the other players profiting from the securitization of low-quality MBS, FNMA and FHLMC were, quite literally, banking on the faulty assumption that US home prices could only go up, and that any price correction would be minor, short-lived, and geographically limited. Of course, that assumption has cost investors more than one-half trillion dollars already.

All this leads up to the events of the past few months. By early 2008, FNMA alone had grown into a company with assets of nearly \$900 billion, and with guarantees on pass-through securities they had issued totaling more than \$2.5 trillion. Of this “book of business,” \$345 billion was in Alt-A loans (non-conforming, “low doc” loans), and another \$51 billion was in subprime. As of March 31, unrealized losses in their Alt-A and subprime investment portfolio totaled \$8 billion (up from \$3.3 billion at year-end 2007). Of course, Alt-A and subprime were the types of loans that FNMA would never have touched a decade ago. To put this into perspective, FNMA’s reported stockholder’s equity at March 31 was just \$39 billion, down from \$44 billion at year-end. FHLMC’s numbers were similarly dismal.



Seeing the continued deterioration of the US housing market, Congress passed new legislation just after Fannie and Freddie reported these troubling first quarter financials. The Federal Housing Finance Regulatory Reform Act of 2008 created the Federal Housing Finance Agency (FHFA) to oversee and control Fannie and Freddie, and granted authority to the Treasury to lend money or inject equity into the GSEs. It was hoped that the Treasury's authority to prop them up would be enough to calm investors and restore confidence, and for a while this seemed to be the case; but as the summer dragged on and housing prices continued to plummet and global economic growth stalled, that confidence evaporated.

According to those familiar with discussions between the Treasury and the GSEs, no one inside the companies could say what the future losses might be. That just wasn't acceptable, either to the Treasury, or to foreign investors, who held an estimated \$5 trillion of Fannie and Freddie debt (and who had the potential to buy much, much more, or—far worse—dump what they held). The Treasury wanted to simply make a cash injection, but again, nobody could guarantee that \$10, \$20, or \$50 billion would be enough to satisfy nervous investors. Ultimately, according to the *Wall Street Journal*, the only decision that the Treasury gave to FNMA and FHLMC was to give the CEO's the choice of agreeing to conservatorship, or the "FHFA would declare them undercapitalized and take them over involuntarily."

Accordingly, on September 7th, the Treasury announced that FNMA and FHLMC had been placed into conservatorship, which, as the name implies, meant that Fannie and Freddie would continue operating, but with the FHFA as the conservator. The conservator has the powers normally assigned to the shareholders and board of directors. Common and preferred stock dividends were suspended (but, importantly, bond holders and other creditors will receive all principal and interest payments). The Treasury will inject capital, up to \$100 billion into each institution, and will receive senior preferred stock in exchange (ensuring that the Treasury will be senior to all existing shareholders, effectively wiping out the outstanding common shareholders).

The effect was immediate and significant. Yield differentials between FNMA/FHLMC bonds and like-maturity Treasuries compressed by anywhere from 20 to 50 basis points overnight (0.20% to 0.50%), bringing down rates on conforming 30-year mortgages by approximately 50 basis points for the week. The Government removed all doubt (at least through the end of 2009) that they would stand behind the creditworthiness of the GSEs' debt and guaranteed pass-throughs.

Of course, the main unanswered question is: Where do

we go from here? The FHFA has mandated that FNMA and FHLMC shrink their balance sheets to a maximum of \$850 billion by year-end 2009, and then by 10% annually until they each reach \$250 billion. Clearly, the plan is to clean up their balance sheets and get back to "blocking and tackling"—namely, securitizing home mortgage loans and supporting the secondary market. Longer term, Congress is charged with the responsibility of deciding what ownership structure the GSEs will use in the future. While all options are on the table, it seems like there are three main choices: The first is to re-emerge as they were—"hybrid" companies (or a single company) with public shareholders but with increased Federal oversight. The second option is to keep them as Government-owned institutions, reverting to the way FNMA was for the first 30 years of its existence. The last option is to have them broken up and liquidated, with their functions completely assumed by the private sector.

With Congress assigned the duty of deciding the fate of these companies, we expect the outcome will be shaped by the prevailing political atmosphere. Republicans have traditionally favored private sector solutions to financial problems, but that is changing, as both parties (and both Presidential candidates) are calling for increased oversight and regulation of financial intermediaries. Likewise, Democrats have favored the Government-ownership of the GSEs, as that provides the leverage to insist that the Agencies provide funds for affordable housing programs. The most likely outcome appears to be the path of least resistance: keep them as public utilities under the ownership of the Government.

Whatever their ownership structure may be, one thing is clear—the GSEs' mission creep is over.

As we are going to press with this month's *Investment Update*, our markets have been roiled by the bankruptcy filing of Lehman Brothers and the forced sale of Merrill Lynch to Bank of America. These two titans of Wall Street may not be the last casualties, as the entire financial sector is convulsing under the weight of bad assets, cash hoarding, and a near-complete lack of trust among firms more accustomed to trench warfare than peaceful negotiations. In short, we have taken a giant step backward in one week, as the Fed and the Treasury apparently used up all of their political capital dealing with Fannie and Freddie.

Events of recent days have forced us to re-calibrate our measures of value and our calculations of what constitutes a reasonable margin of safety for high quality investments. In this ultra-volatile environment, we don't have the luxury, even as long-term investors, to ignore rapidly-changing conditions.

