

What a quarter it has been in the stock and credit markets – and in the Smith family! When the subprime mortgage crisis filled the headlines, we wondered if there just might be something to that old stock market adage, *sell in May and go away*. But sure enough, September arrived, and if you had been away during July and August you wouldn't have known a lot happened, when in fact, major dislocations and changes occurred.

If you left in May and didn't come back until September, you'd think little had changed, by outside appearances, in the lives of our daughter-in-law, Millie, and our son, Justin. On the contrary, there was *very little* about their lives that did not change. Millie, barely showing in May, delivered a beautiful, healthy, full-term baby girl, Grayson Wynn Smith, on September the 18th. Justin notes that Grayson's birthday *just happened* to coincide with the Federal Reserve's decision to cut interest rates by ½% for the



first time since 2003! Also, just days before, Justin learned he was counted among the 30,196 persons who passed CFA Level II, out of a world-wide field of 71,897 that took it. After spending a full day with Millie in the labor room and an evening in the operating room (for the C-section), Justin, given the choice of giving birth himself or taking CFA level III next June, said he'd choose the latter every time. *What a difference a quarter makes.*

On the financial side of things, last quarter the headlines began with some bad mortgage loan practices in the US and continued to the point of world credit markets freezing up with the stock market feeling the effects. This perfect storm was created by a number of factors all coming together at once to work its mischief. Slack mortgage underwriting practices, loose rating agency practices, a destruction of confidence, excessive leverage and greedy investors all combined to create one of the worst credit markets in memory. Before we explain the turn of events, the following is a worthwhile story to keep in mind:

There is the old story about the market craze in sardine trading when the sardines disappeared from their traditional waters in Monterey, California. The commodity traders bid them up and the price of a can of sardines soared. One day a buyer decided to treat himself to an expensive meal and actually opened a can and started eating. He immediately became ill and told the seller the sardines were no good. The seller said, "You don't understand. These are not *eating sardines*, they are *trading sardines*."¹

Like the sardine traders in this story, many credit market players over the last few years were attracted to speculation, never bothering to eat the sardines they were trading. For background, in the early '90s, investment banks created a new type of security called an Asset Backed Security (ABS) which was a very helpful instrument. Essentially, investment banks would take a thousand mortgages or car loans or commercial mortgages or bank loans and roll them up ("can" them) into one security. You could have a

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Residential Mortgage Backed Security (RMBS) or Commercial Mortgage Backed Security (CMBS) or a Collateralized Loan Obligation (CLO) and then a Collateralized Debt Obligation (CDO).

Over time, investment banks put together an alphabet soup of securities and derivatives with this “asset-backed” paper. The banks could mix and match risk in these loan vehicles. The combinations were endless. It can be quite a complex task to analyze and assess what the underlying assets are and what the risk is. So, to a great extent, that analysis was left to the rating agencies like Moody’s, Fitch’s, and Standard & Poor’s. For all practical purposes, institutional buyers would look at the general classification of the security and then at the rating; if the rating was high and the dividend yield was attractive, they would buy the security, never knowing what asset actually “backed up” the security. Not unlike buying a crate of sardines without sampling them first; this wasn’t a problem as long as the loans were performing (or the sardines were good) – in other words as long as the underlying borrowers made their payments. Here’s where the subprime mess enters the picture.

Many of these loan securities included subprime mortgages that were adjustable-rate mortgages, or ARMs, also called “exploding ARMs.” These loans are so-named because they carry low teaser rates that often reset dramatically higher, increasing the borrower’s monthly mortgage payments by 25% or more. These types of loans increased materially in 2005 and 2006. In that period, *about 80% of all subprime mortgages originated were ARMs.*

In the beginning, subprime loans were made the old-fashioned way. You had to have an 80% loan-to-value ratio on your house, prove you had a job and could actually pay back the loan. There was also a real lender (Bank) who held the loan on its books. In 2005 and 2006, that was no longer the case. Lending standards loosened, since the ultimate owner of the loan was an institution who never did a risk assessment on the borrower. Consequently, many overzealous mortgage brokers had a field day selling loans that people could afford for the next six months... but not for the long-term. Sounds a bit like “trading sardines” and not “eating sardines” doesn’t it? The industry seemed to forget that these weren’t just “trading” mortgages, these were “living” mortgages, “breathing” mortgages and “Oh my word honey, have you seen our next payment?!?” mortgages.

According to reports from loan counseling agencies across the nation, the main reason homeowners give for falling behind on their mortgage payments is *not* due to a change in personal circumstances (such as a job loss), but instead, they are unable to make the *increased payments* on their ARMs. When these borrowers stopped making payments on their mortgages, many of the “canned” securities stopped paying their dividends. When the owner of the securities realized that some of the underlying loans were made up of subprime mortgages and ARMs that were resetting, they wanted to sell them as fast as they could. Institutions, hedge funds, and banks were all trying to get these canned securities off their books. The credit market for these assets dropped like a rock because no one wanted to buy them. The whole credit market seized up and stopped functioning. Thus you heard that hedge funds, heavily invested in RMBS, were unable to payout partners who wished to liquidate their holdings.



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This affected the corporate bond market and the stock market because the hedge funds that needed cash but couldn't sell these securities turned around and sold what they could sell – stocks and bonds. You had a rash of sellers flooding the markets, coupled with fear of a credit collapse and a recession. Some canned securities with subprime exposure have been selling for as low as \$.33 on the dollar. The problem today is that no one knows the values of some of the mortgage-backed securities. And if you don't know, you don't buy. Today, even very well-designed canned securities with no subprime exposure are selling at discounts, if they are selling at all. Secured loans that banks made, backed by real assets, were valued as if they were riskier than *unsecured* loans issued by corporations. This makes no economic sense whatsoever. Anyone who has ever had a yard sale knows that at the end of the day, when *everything must go*, many good assets are sold at a fraction of their value. This has been the case in the credit markets where people cannot assess the risk behind their purchases.

Finally, with so many subprime mortgages resetting, you have a number of homeowners that are in foreclosure. As lenders foreclose, they put homes on the market for prices well below market prices because they are in a distressed situation. Again the law of supply and demand leads to a glut of homes on the market, and more sellers than buyers. The result? Falling home prices.

The economic fallout for the US is not clear. Mortgage lenders and home builders have laid off thousands of workers. Credit is harder to get today than it was three months ago and so consumer spending may slow. This is one reason why the Federal Reserve lowered interest rates in September, to cushion the economic blow of the housing decline and the credit squeeze.

Disruptions in the markets, as we've often said, are a normal part of investing. This last quarter is a testament to that truth. Regardless of the turbulence, with the recent cut in interest rates, we think stocks represent a very good value here - so long as there is not a recession. So far, the only area of significant economic weakness has been housing. We think the market is looking hard for evidence of a decline in consumer spending and any evidence of stagnating economic growth. If upcoming economic data show continued economic strength, recession fears will recede significantly and we think the stock market would rise further.

As a firm, we pay attention to the macroeconomic trends, but we focus even harder on the microeconomic details in the businesses we follow. We believe requiring a margin of safety when we buy shares of a business goes a long way toward protecting our portfolio from permanent capital loss. In other words, we believe that buying companies that fall into the “eating sardines” category and staying away from “trading sardines,” regardless of the most recent “trading price,” is a recipe for success.

We don't know what will happen with credit markets or equity markets as this slow motion train wreck plays out. What we do know is that we have confidence in the investments we own to not only weather a storm, but to take advantage of the opportunities these storms create. Keeping one's cool, whether in markets or in labor and delivery, is dependent on maintaining a correct perspective, something we at Jonathan Smith & Co. prize highly both in ourselves, and in the businesses we invest in.

¹ Sequoia Fund, Inc., annual report for 1986 (emphasis added)