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## My Perspective on the Sub-Prime Mortgage Credit Crunch

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I'm sure you've been following the sub-prime mortgage fiasco, so I thought I'd give you my perspective on the situation.

Briefly, increasing default levels in mortgages granted to borrowers with poor credit histories have caused credit worries that go beyond the sub-prime market. Countrywide Financial, for example, the largest mortgage lender, just borrowed \$11.5 billion from a consortium of 40 banks. In my view, this is a positive development that may stave off future anxiety. Credit worries have grown as the secondary market for mortgages all but disappeared in recent weeks. Mortgage lenders rely on the secondary markets to borrow money to make more loans (mostly, in the case of Countrywide, prime mortgages). With the sub-prime situation, that market for loans has greatly diminished, since banks are worried about the value of such loans.

Hopefully this will just be a temporary crisis, since normally markets adjust once the psychology calms down. What's happened here, in my view, is that investors for the last few years have lost perspective on risk, so they buy even "junk" securities, hoping to get higher and higher returns. Regrettably, the rating services, such as Moody's, have rated some such securities AAA, which they certainly are not qualified to be. Now, with the sub-prime situation, investors are suddenly waking up to the reality of risk and volatility and are adjusting accordingly.

So far, most of the pain has been in the "sophisticated investor" arena, e.g. hedge funds. For example, the Goldman Sachs Global Equity Opportunity hedge fund lost 28% so far this month (a \$1.4 billion loss), so now

Goldman is reducing fees on this fund, trying to lure back investors. Several French and German banks have taken large losses, since they carried mortgage securities on their books, which were backed by sub-prime loans, and now there's basically no market for such bonds.

This contagion could spread, however, as banks are forced to tighten up their lending practices. Jumbo mortgages, for instance, have now jumped up to 8% and higher for rates on 30-year loans. Also, billions of dollars of adjustable rate mortgages are due to reset at much higher rates in the next year; that could increase default rates. Such developments could serve to accelerate the slowdown in the housing market.

However, market observers are pointing out that the global economy is quite strong, so hopefully we'll be able to weather this storm without going into a recession.

As you know, I've been predicting a 10 to 15% market downturn, since it's been over 4 years since the last one. It's actually a healthy thing to have the market drop significantly, since it cleanses the market of speculative investors, leaving long-term investors like you and me.

As usual, I'm advocating that we stand pat and not make any radical changes to the portfolio. Let me emphasize that no client portfolios contain sub-prime mortgage securities. So far the Dow Industrials has dropped 8.1% since it peaked on 7/19 at 14000.41. We should take in stride additional drops in the Dow to perhaps as low as 12000.

Client portfolios have dropped since June 30th only 3 to 6%. Since the beginning of the year, portfolios are flat to up 4%. Call me if you'd like to discuss how your particular portfolio is doing.