



INVESTMENT NEWSLETTER

CEP FINANCIAL, LLC

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**FEDERAL GOVERNMENT
HELPS CONSUMERS BUY
HOUSES.**

**MORTGAGE COMPANIES
SELL PROBLEM
MORTGAGES.**

**COMPLEX INVESTMENTS
(CMOS) HIDE THE
PROBLEMS WITH MORT-
GAGES.**

**INVESTORS BORROW
MONEY TO BUY THE
CMOS.**

**ACCOUNTING
PRACTICES COMPOUND
THE PROBLEM.**

**FEDERAL GOVERNMENT
HELPS COMPANIES
FROM GOING
BANKRUPT.**

The Investment Letter is mailed quarterly to our clients and friends. It is compiled primarily from reports in the Wall Street Journal, Houston Chronicle, Morningstar, advisors Littman Gregory, columnist Bob Veres, and the Patriot Post newsletter.

WHAT CAUSED THE 2008 MELTDOWN OF THE MARKETS?

As far as I can tell this mess started when the federal government (I think with good intentions) through Fannie May and Freddie Mac inserted itself in the US economy through its disastrous plan to ignore financial reality and strongly encourage financial institutions to make mortgage loans to non qualified buyers.

Because Fannie and Freddie were willing to buy mortgages taken out by people who weren't qualified to own houses, the mortgage companies started giving mortgages to anyone who could breathe. These companies also saw an opportunity to make more money by issuing mortgages with terms very favorable to them (adjustable rates, interest only loans, balloon payments, etc, etc). Then, the mortgage companies sold the mortgages to Fannie and Freddie and anybody else who wanted to buy them. But first, they sliced up hundreds or thousands or mortgages and put a piece of each mortgage (both problem mortgages and good mortgages) in packets called CMOs or Collateralized Mortgage Obligations.

Now CMOs are very hard to understand. The slicing and dicing of different mortgages and combining the different slices in different ways can be very complex.

But despite their complexity, the CMOs were very popular with some investors because they were diversified (less risk of default, they thought), they had high rates of return and, if they wanted to, they could sell the CMOs to somebody else. Lots of people wanted in on this new type of investment with low risk and high rates of return.

Because they looked like such a good deal, some investors used not only their own money to buy these CMOs, but they went to large banks and borrowed money to buy more of these CMOs.

This is where the Federal Reserve comes in. The Federal Reserve controls short term interest rates in our economy. To keep economic activity high, the Federal Reserve kept short term interest rates very low. So the investors that were buying CMOs with borrowed money got short term loans because they had lower interest rates. They simply refinanced when the loans came due. (This is called borrowing short and investing long – this is risky but profitable as long as things are going well)

The banks were interested in lending the money because the loans were profitable and they had collateral (the CMOs) that they could sell in the open market if the investor defaulted on the loan.

The banks could tell what the CMOs were worth because the CMOs were bought and sold every day in the market place. Besides they didn't even have to track the market values of the CMOs because the investors kept the value of the CMOs on their books at market value (this is called mark to market accounting)

In fact the banks were so comfortable with lending this way some of the investors borrowed close to \$40 for every dollar they invested.

(This is called overleveraging. It is risky, but can increase your profits dramatically).

Now some investors thought maybe they should be more conservative. So, they made a deal with insurance companies. The investors paid a small fee to the insurance company and in return, the insurance company would pay the investors if people stopped paying the mortgage loans (remember them from paragraph 1)

The insurance companies thought this would be easy money because in the past few people had defaulted on their mortgages. These arrangements were called credit default swaps.

In fact, they thought it was such easy money, they would sell a credit default swap to anybody. It didn't matter if you owned a CMO or not. And they sold a lot of them, about \$62 trillion of them. That four times the value of the entire US economy.

Add to all of the above, the fact that some of the banks didn't report their loans and CMO investments on their financial statements, but instead kept some of this activity in accounts that investors and creditors couldn't see. This was called off balance sheet financing with structured investment vehicles or SIVs.

Despite the complexity of all these arrangements things worked pretty good for a number of years, but after the Federal Reserve started raising short term interest rates the CMOs and the loans started to look a little shaky.

In 2008, the wheels came off. The combination of the problems with Fannie and Freddie, the bad mortgage lending, the complex CMOs, the high leverage, the short term loans, the credit swap defaults, and an increase in short term loan interest rates, and an increase in mortgage defaults spooked the

banks. And they stopped refinancing the short term loans.

When the loans couldn't be renewed, the investors who owned the CMOs had to sell the CMOs on the open market but now there were fewer buyers. This might have been OK in the old days when you didn't write down the value of the mortgage until the borrowers stop paying, but now the CMOs had to be written down to their market value and since no one wanted to buy these investments, their market value came in pretty close to zero. When this happened the investors who had borrowed money could not pay back the loans, the banks couldn't collect the loans and it looked as if the insurance company had much more in liabilities than assets.

What a mess, but now it gets even worse. Because the investors who did this were a major part of the U.S. financial system, there was a real risk that if these companies went bankrupt (and they certainly should have because of all the bad business decisions they made) the whole US economy might shut down.

So the Federal Government, again with the best of intentions, steps in and bails out most of these banks, investors and insurance companies and a couple of car companies to boot.

Whether or not this turns out to be a smart idea is yet to be seen, but you have to be skeptical and the numbers are staggering.

And nobody saw this coming, not Alan Greenspan or anybody else at the Federal Reserve, not Warren Buffet or anyone else in the investment community or anybody at all in Congress.

Now we collectively have to figure out how to keep the economy going, and make sure we fix the system so that this doesn't happen again.

We may be in for a couple of very bumpy years.

The good news in all this (yes honestly there is good news), is that if you have a decent financial plan, you don't have to sell your equity investments while the market recovers. In fact there are now great opportunities in both the equity and fixed income markets. We will discuss these opportunities in our next newsletter.