# Capital Drain

Rick's investment opinion newsletter September, 2007 v.3 no.8

Hi Readers,

I got some feedback from readers on the last two issues:

- "Too technical."
- "Too basic."

Obviously, I won't be able to please everyone all the time. My goal writing this is to keep the discussion relatively basic, for the non-professional investor. When some technical topic comes up, I'll try to explain it in a way that people who've never taken a finance or economics course could understand.

To my MBA classmates and friends, I know this will make some parts too simplistic. I hope you'll be able to skim over those easily.

It's been another interesting month, eh? In my opinion:

## Executive Summary:



As I've written before, I think everyone is best off with a **broad diversification** that includes at least **3/4 overseas** assets (easily purchased via US mutual funds and Exchange Traded Funds (ETFs)), reflecting the distribution of world economic activity.

This is a good time for investors to be conservative, to be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

## The Details:

> "No chief investment officer is going to get fired for deciding to get out of hedge funds right now," Cedar Partners' Bonnefoy said. "You can always reinvest later on."[1]

OK, the Federal Reserve just cut interest rates half a percent. What is that going to accomplish?

First: what will it NOT accomplish?

Rates lower by half a percent will have negligible effect on the sub-prime mortgage mess. For the most part, those borrowers were so far overextended that it would take mortgage rate decreases of several whole percent to keep them afloat. The variable-rate mortgage rate resets will continue pushing thousands of weak borrowers into default over the next six months. Home prices are going to continue to slide, with only a modest new number of good-quality buyers taking advantage of the imminent lower mortgage rates.

Nor will lower rates fix the liquidity drought among short-term borrowers. The issue there isn't cost (of money) it's availability. Borrowers still have to earn the trust of lenders, by showing that the borrowers have not invested in overly-risky CDOs.

The Fed Rate drop is intended to show the capital markets that the Fed "feels their pain" and cares and wants to help. That's nice. From the Fed's point of view, though, the message is less cheery: the housing crunch is depressing the overall economy sufficiently that inflation is less scary than recession. Inflation is still hovering near (and above) the Fed's preferred maximum level, so presumably recession has become pretty scary.

The other immediate effect of the rate cut is that the dollar's fall relative to other currencies will certainly accelerate. Gold will probably continue rising, too. Housing, as I said, will keep falling. The bright spot is that the world-wide tide of rising central bank rates may be cresting, so bonds are becoming more attractive.

I don't mean to tell anyone how to invest their money, but my personal preferences are: non-US developed countries over developing countries or US. Bonds over stocks. The mutual fund PSAFX is good for non-US short-term bonds, and PFBDX is good for medium to longer-term. The exchange traded fund (essentially a mutual fund) EFA remains an easy way to buy world-diversified non-US high-quality stocks.

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[1] Svea Herbst-Bayliss, "Hedge fund losses prompt exits as deadline looms," The Washington Post, 14 Aug 2007, Reuters Group PLC, 14 Aug 2007 <http://www.washingtonpost.com/wp-dyn/content/article/2007/08/14/AR2007081400182.html>

One of the oft-cited advantages of using financial **derivatives** such as CDOs was that they "spread out the risk." The theory was that sophisticated rational financial companies (think hedge funds or investment banks) would each take just a small share of the risk, so that even if-- it could never happen, of course-- even if the investment climate turned bad, no one would be hurt much.

You've seen that things didn't turn out that way. You'll see more before this is over. What happened to the theory?

First, the basic see-saw of fear and greed. When the economy and the financial markets all look rosy, greed overcomes fear and investors believe they're "**Willing to take the risk**." What they were **not** was **willing to take a loss**. When bad news broke, many of those willing risk-takers took fright. In a heartbeat, a great herd stampeded from greed back to fear. Trying to un-take their risks, many investors were simultaneously trying to sell some of the same derivatives. The bottom dropped out from under the price, and now most of the investors are holding those risks, those derivatives, those losses, because they can't get rid of them.

Second, the risk was spread so well that no one knows where it all is. It even showed up in our money market mutual funds. Now healthy companies are eyeing each other with suspicion: "Are you healthy too, or one of the infected ones?"

On a normal day, companies with short-term excess cash lend it in the commercial paper market to other companies with a short-term cash shortfall. No big deal; everyone gets paid and no one gets hurt. But then, when it turns out that you might not get paid... fear, and a withdrawal from inter-company lending.

Third, a surprising number of companies were "cleverly" playing the interest-rate spread between long-term relatively risky debt and short-term supposedly risk-free debt. The long-term debt earns higher rates, so these companies pocketed the difference, until... they couldn't get the short-term loans anymore.

This is essentially what banks do. Picture Jimmy Stewart, explaining banking to the mob trying to withdraw their deposits. Government backstops like the FDIC and the Federal Reserve Bank were created specifically to make it safe for depositors to trust banks. The problem is that the clever companies weren't banks, and there is no such easy backstop for them. When the risk of their long-term loans became apparent, they were suddenly unable to renew their short-term borrowing.

Fourth, there was the SEP Field. That's not a technical financial term; it's from The Hitchhiker's Guide to the Galaxy. When danger threatened, they'd switch on The SEP Field: Someone Else's Problem. It didn't make the situation any less dangerous, but it allowed everyone to stop worrying. It became Someone Else's Problem.

That's a good analog to what went on evaluating some of this bad debt. Lenders gave money to unsuitable home-buyers and lots of junk-bond-supported financial deals (which are yet to blow up, but a recession will change that) knowing that the loans would be sold off and securitized as CDOs. SEP. The rating agencies gave the CDOs high ratings, but claim that's "just an opinion" (it's the sole source of their commercial activity and income) and that they assumed buyers would do their own investigation. SEP. The CDO buyers assumed that the rating agencies meant what the ratings said, and likely also assumed that lenders were using the same good fiduciary sense they'd used over the past 30 years. SEP.

Suddenly, the purchasers of those CDOs learned that it was so their problem. The banks and others who lent to those purchasers learned that is was their problem. And so on, so there was and is a big problem with liquidity, as I described last month.

It's time again to check your **credit report. It's free**, once per year per credit agency, to get a copy of your report. Since there are three agencies, that means that you can go to one agency every four months.

This month I'll go through the **step-by-step instructions to visit Equifax**.

- Go to https://www.annualcreditreport.com
- Where it says "Start here," select your state and press "Request Report"
- Fill out the online secure (https) form, then click Next
- Select Equifax, the click Next
- click Next again
- Now at the Equifax site, confirm the info shown and click "Continue"
- Answer their security questions (usually asking you to confirm that you know some info about one of your accounts) then click "Continue"
- Click "No thanks, I don't want my score." It costs $8 if you do want it. What we're getting is the free report.
- Now on Equifax Step 2 of 3, check to be sure none of the "Limited offers" is selected. Click "Submit"
- Now on Equifax Step 3 of 3,
  - make a note of the transaction code, **FACTnnnnnnnn** where n is a digit. You can use this to review the report anytime in the next 30 days.
  - halfway down the page where it says "Product," click "view my product"
  - You should also get an email from them, with a link to view this report.
- When you get the report, click on 'Print Credit Report' in the left column. This gives you all the info on one page.
- Read through the report for anything suspicious. You don't need to be sure it's up to date, or that the outstanding balances are precisely correct; just be sure there are no accounts you never had, no unpaid balances you know you paid, etc.
- Save a copy so you can compare it from year to year.

**DO** try this at home! (NOW) It takes less time to do than it took to write this.

That's enough for now, I guess.

If you have any questions, please write or phone. If you want to read more, I've got a web site (see URL below) with archived editions of this letter and some links to other interesting sites. There's also a weblog where I discuss the process and progress of starting the mutual fund.

Please feel free to forward this to any friends who may be interested.

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Take care,

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"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare