The Capital Advisor presents I:
A Corporate Treasurer's Guide to Investment Challenges

GSE WATCH

Fannie Is In Trouble Again. Shouldn't You Care?

The latest debacle at Fannie Mae is perhaps the deadliest in its existence as a Government Sponsored Enterprise (GSE). The latest discoveries by the Office of Federal Housing Enterprises Office (OFHEO) could ignite a firestorm that may result in dramatic makeovers at the very heart of the organization. As a corporate treasurer, should you sell your Fannie Mae bonds or should you buy more because the yields are higher? Should you be oblivious of the financial headlines if your goal is to hold your investments to maturity?

Stay the Course: Investors are rightfully concerned with the latest development at Fannie Mae, given the sizable holdings of the triple-A rated agency debt in many bond portfolios. For corporate cash accounts, we have been advising to stay the course in holding agency debt with maturities less than three years. Earmarking for unexpected cash outlays and the intent of minimizing marked-to-market losses may suggest lesser allocations to GSE bonds of longer maturities. In a nutshell, we believe that there is no strong fundamental credit basis to support an outright retreat from the very highly rated agency bonds solely based on the reported management mishaps at Fannie Mae.

The GSE debt issued by the likes of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, are an entirely different class of investments from stocks and subordinated bonds issued by the same companies. In fact, both Moody's and Standard & Poor's, two of the nation's largest credit rating agencies, view the GSE status and their central role in the US government's housing finance policy as the cornerstone of their agency debt ratings. It is conceivable that Fannie Mae could receive downgrades on its subordinated debt ratings, currently at Aa2/AA-, as the result of the findings, its public agency debt issuance and those of other housing GSEs should remain AAA.

To fundamentally weaken the credit paying ability of Fannie Mae would require an act of Congress to remove its GSE status. To date, even the harshest critics in Washington, and all proposed bills introduced, would not entertain such an idea. Based on the government's experience handling the Farm Credit System crisis in the 1980s, we believe there is a very good chance that the existing debt holders would be paid in whole even in the very unlikely scenario that Congress took away the GSE status.

Too Big to Fail: What OFHEO uncovered merely confirmed the urgent need for further tightening the processes and procedures at the GSEs to minimize the "moral hazard" on the federal government. Critics have long claimed that Fannie Mae and Freddie Mac, with their quasi-government status and lower funding costs, built tremendous financial leverage on their balance sheets

October 4th, 2004

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with mortgage portfolios. As of June 2004, the combined agency and mortgage debt issued or guaranteed by the two agencies alone amounted to $4.7 trillion, or 21% of all public and private debt outstanding in the United States. A failure or insolvency by either of the institutions could cause devastating effect on the housing finance sector and worldwide capital markets, and would require costly cleanup efforts by the government.
The OFHEO report detailed the preliminary findings at Fannie Mae, after eight months of investigation, that raised series doubts about the accuracy of GSE's published financial results going back several years. We fully expect the report would accelerate the government's effort to increase capital surplus with better command and controls, and more transparent financial reporting, at both Fannie Mae and Freddie Mac to further improve the safety and soundness of the entities. The GSEs may go through the process of extreme makeovers in the years to come. For now, at least, we believe they are too big to fail.

Informed Decisions: The decision to stay the course on Fannie Mae does not mean indiscriminating buying without regard to headline risks that are, and will be, present in the financial press. We are cognizant of the political risks as a major headwind in the price performance of GSE debt, and believe such risks should not reduce investors' appetite for short to intermediate term agency bonds. We are very confident of the strong credit quality of prime residential mortgage loans that make up the bulk of the GSEs balance sheet. The incremental borrowing cost by Fannie Mae, as a result of the headline risk, should not significantly reduce its profit margin to diminish its ability to fulfill its debt obligations.

Of several credit indicators on our radar screen, we are especially interested in the GSE's capital adequacy. We notice that despite annual earnings per share growth of 23.4% in the last five years and accumulation of $19.6 billion of retained earnings, Fannie Mae's common equity grew only 9.3% annually, and $3.9 billion cumulatively in the same period. Besides share buybacks of $5.2 billion, a major portion of the remaining $10.5 billion may have represented hedging losses that were not recorded on its income statements. The company has entered into an agreement with OFHEO to maintain a targeted capital surplus 30% in excess of the minimum capital requirement within 270 days. The ability to maintain this comfort level, in addition to several other oversight measures, will influence our decisions whether to increase our investments in longer maturity Fannie Mae bonds.

This article originally appeared in *the Capital Advisor,* a web-based newsletter of the investment advisor, on October 4th, 2004. Go to www.capitaladvisors.com for more information.

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