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The Subprime Flu

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When the obscurely named ABX.HE.BBB-.06-1 crawled from Wall Street trading computers into millions of living rooms through the national media last February, a system meltdown was fast approaching.

The ABX isn't an Internet worm; it is a specimen of "asset-backed credit default swaps," or a quasi insurance policy on borderline investment-grade bonds repackaged from subprime mortgages issued in the first half of 2006. As worries about the subprime market developed, the cost of insuring the bonds against defaults surged from 393 or 3.93% a year over Treasury yield at the end of 2006 to 1415 on February 27th, coinciding with the day when a "Shanghai flu" caused worldwide stock markets to slide.

Unlike the Chinese stock markets, which have fully recovered since, the subprime flu in the U.S. is continuing with regular reports of rising defaults, fraud, and more mortgage lenders in trouble. Some pundits are saying we may not see the market stabilizing until late 2008, when most of the borrowers of subprime mortgages, about 40% the total volumes in 2005 and 2006, see their fixed teaser rates come to an end while the value of their homes stagnate or even fall in some markets. Recent data also showed the contagion starting to spill over into the "Alt-A", or near-prime, sector.

Difficult Diagnosis

As cash investors, we may be tempted to think all this has little relevance to us. In reality, however, this notion may not be altogether true. For one thing, tough inflation "Fedspeak" notwithstanding, there is the increased likelihood of interest rate cuts, or the "Bernanke put," as a short-term fix to stop the stampede of the mortgage problems into construction spending, unemployment, consumer confidence, market liquidity, credit, etc.

As a credit issue, a multitude of factors in the last decade has made mortgage exposure harder to discern. The usual suspects, namely regional banks, may be least exposed as most of the subprime loans are in the hands of specialty lenders and investors. Concerns with Wall Street firms' exposure were lessened after the upbeat commentaries by executives at recent earnings calls. In fact, the securitization market may have achieved its intended purpose - to redistribute returns and pains to investors of all strides from foreign central banks to hedge funds. As mentioned recently in an investor conference by Richard Kovacevich, CEO of Wells Fargo & Co., sorting through who has what exposure to the subprime sector may ultimately be next to impossible - but think Fannie Mae, Freddie Mac, GE, AIG…even your money market fund.

Tough Medicine

Figuring out who the culprits are may not be tricky – they're likely lenders, borrowers, regulators and even the investors among us. When we went out and demanded a few extra basis points in yield, did we loosen up our discipline by willingly accepting something that contradicted our inner risk conscience? Was "everyone is doing it" enough of an excuse to reach for yield while forgetting the safety and liquidity principles?

Wall Street will always have the ingenuity to create new products to satisfy our thirst for returns, but maybe we should reflect upon when and how we began to forego a steady diet of risk aversion.

Investors appear to need a reminder every few years to respect the self correcting forces of the financial markets. Corrections can be hurtful but not always harmful. What happened in the subprime market serves to remind us that return enhancing strategies involve measured risk-taking with an eye toward both the up and down side potentials. This month's Spotlight Research may help shed some light on that subject.