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FINANCIAL ALCHEMY

The myriad of credit/housing/banking crisis type upheavals over the past few months brings full circle the widespread *financial alchemy* that has been peddled the past decade or so. Alchemy in this sense refers to the transformation from something of little intrinsic value to something worth much more. The financial alchemists (brokers and bankers along with their willing government partners) insisted along the way that all was fine. The packaging of small individual transactions such as mortgages into larger groupings (what is called securitization) is not in itself problematic other than the responsibility factor is disconnected. In the not too distant past, your mortgage was issued, managed and serviced all under one roof. Today, the issuing bank or broker likely sells the loan as part of a package days or weeks after the closing, thereby reducing them to a transactional mentality. This has proven important as many mortgages were issued where no reasonable basis for re-payment existed. The narrow view outpaced the broad.

"Alchemy...refers to the transformation of something of little intrinsic value to something worth more"

The larger problem lies in the leveraging of these loans in the manner that the Collateralized Debt Obligations (CDO's) borrowed (from investors) 10 times the value of the underlying loans. Leverage works both ways of course and when the bets proved wrong these not so small hedge fund deals unraveled. It is estimated that the CDO's hold about \$2 trillion in mortgages and raised another \$15-20 trillion from investors (hedge funds and foreign investors to a large extent). For context, the net value of publicly traded stocks and bonds in the U.S. is about \$19 trillion. Admitted losses from banks now are approaching \$500 billion with more likely to come.

The recent housing rescue package (\$300 billion) and the Fannie Mae and Freddie Mac bailout (some estimate it will top \$1 trillion) appear to benefit the markets, particularly the beleaguered banks in the near term. The longer term implications, however, of failing to correct the imbalances and abuses in these institutions when the opportunity was instant could be serious. Fannie and Freddie spent \$170 million on lobbying efforts over the past decade and it appears these dollars were well invested. The mission of these "GSE's" (Government Sponsored Enterprises) is (was) to provide liquidity in the mortgage markets. Other entities could perform this function today but "status quo" won the day and nothing has changed.

GAME CHANGER

While the credit market / housing problems have been significant, the real "game changer" has been the price of oil. While recent prices show that the run up is not entirely vertical, the 50% + change over the past year has stoked the fires of inflation. Year over year inflation is running about 5% largely because of increased energy/food costs. If oil moves back down to the \$100 per barrel range, this rate of inflation is cut in half. As one of our colleagues likes to say, "The cure for high oil prices *is* high oil prices". Miles driven in the U.S. have fallen by about 5% in recent months. Assuming the prices stay relatively high this demand change could be permanent unlike the 1970's where temporary changes were quickly erased as prices fell. One is left to hope that the policy mistakes made on the handling of the credit crisis aren't repeated here.



REAL ESTATE

Dan Sullivan, founder of The Strategic Coach, has a phrase for lessons learned from negative events. He calls this "The Greatest Teacher". Indeed, the now three year long pull back in real estate prices (remember our mantra markets go up and down...not up and up), has likely brought some good along with the bad. In certain former "hot markets", prices are down 25% or more from their peak. Hopefully this has brought into the sphere of general understanding that yes, even real estate is not a vertical market. There are some signs that prices in the hardest hit areas of California are starting to rise again perhaps signaling a market bottom. This will not, however, totally solve the dilemma with an estimated 15-20 million homes that owe more on their mortgage than the house is worth. It may take a few years for some of these markets to fully rebound.

This seems like a good place to restate the actual, rather than imagined, rate of return on residential real estate. Factoring in all costs (taxes, maintenance, insurance, etc.), the long term return is about the rate of inflation plus 1% - 2% annually. Yes, there certainly are exceptions to this average but for most of us this rings true. Take a look at www.zillow.com and plug in your home address. Consider what you paid 5, 10, 20, 30 years ago and approximate the total of costs over the years. Pull that out of the estimated value and compute a simple annual return. Our guess is the figure is a mid single digit percentage. Residential real estate of course has what economists call "utility" or usefulness. We all need a roof over our heads and the house provides that and many other utility functions. This adds to the worth in our minds but may not translate into the actual return.

TRUTHS (THE FIRST OF A SERIES)



1. *There are never any vertical markets – only vertical imaginations.* High tech stocks in the 1990's; real estate in the 80's and 90's; oil in 2008. All of these appeared to be (to some) on an unstoppable vertical ascent and in each case failed to live up to the hype. Examples of these type market conditions are plentiful. Every few years brings a new version. Market cycles can seemingly defy this truth for awhile but markets always adjust and correct towards equilibrium.

It is easy to lose focus of this truth within the euphoria that accompanies these almost vertical markets. They tend to give way when greed replaces sensibility. Repeat after me..."Markets go up and down, not up and up."

2. *We live in a non-linear world.* Our brains are wired to expect linear progressions despite a largely randomized non-linear world. If we study hard, we make good grades; if we work hard, we make more money; if we watch our diet, we lose weight. All of these contain correlated items or variables. The fact that they are correlated, however, does not imply one *causes* the other.

Hurricanes, earthquakes and floods all occur randomly in nature. We cannot reliably predict them. As much as we would like for financial markets to behave differently, they too follow a non-linear structure. Try to hold both of these traits simultaneously in your mind. It should help lessen your anxiety and increase your confidence.