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# PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

## Market Update

By Che H. Lee, *President*

Recently, the market dropped over 10% (a.k.a. "correction") before partially rebounding. There was palpable fear among investors and market participants during the decline, as they were pounded by one negative article after another from the media on the housing and liquidity crises. The fact that we are coming out of an unusually long period of low market volatility made the recent correction seem all the more jarring.

Much of the market weakness relates to the 1) problems in housing and related mortgage markets, and 2) unraveling of the private equity phenomenon. Let's first talk about the housing and mortgage markets.

For several years leading up to 2006, the housing market boomed. As with prior up-cycles, lenders got sloppy and careless, funding a lot of mortgages with inadequate pricing and documentation. Borrowers with poor credit histories, known as sub-prime borrowers (SPB's), were able to obtain ready financing to buy houses. Some were legitimate borrowers pursuing the dream of home ownership. However, many others were speculators, hoping to flip the houses in a strong market for a quick profit. These borrowers never intended to make mortgage payments for long, because they had planned to sell their houses quickly, pay off the mortgage, and keep any appreciation in the interim. This all worked fine as long as home prices kept heading north. The lenders were happy too, because they still made money on these "short-term" mortgages, having pocketed the loan origination fees already.

The terms of these sub-prime mortgages were too enticing to refuse — basically they were "don't worry, be happy, pay later" loans. Most of them were adjustable-rate loans, with the initial rate fixed at some temporarily low level, before adjusting upwards. One reason lenders were able to make these imprudent loans was because a large group of investors (namely hedge funds) was desperate to buy securities that gave them what *appeared* to be high, stable yields. Through a process called securitization, much of the suspect mortgages were packaged as securities (MBS) and sometimes further sliced and diced into collateralized mortgage obligations (CMO) and sold to these hedge funds. By doing so, the lenders pushed most of the default risk onto the hedge funds, freeing their balance sheets to start the lending process all over again and grab another round of origination fees. The hedge funds further risked their investors' money by borrowing to leverage the spread they were earning from these MBS/CMO over their then unusually low borrowing costs.

The lenders were only too eager to oblige. As the housing market roared on, the collateral securing the income stream from these MBS/CMO was viewed as rock solid, and the appetite for the securities grew by leaps and bounds. Lenders were tripping over each other to lend money to the hedge funds.

This arrangement worked wonders for a while, until the expected yield on the MBS/CMO failed to materialize, because SPB's defaulted on their mortgages in droves as rising housing values came to an abrupt halt due to reduced market liquidity. Despite hedge funds being hailed as the miracle solution to a stagnant stock market, the tables turned quickly. As the performance of the hedge funds started suffering, the investors bolted for the exits, demanding their money back. Not only were these hedge funds no longer able to buy these MBS/CMO, they were in fact forced to *try to* sell these deteriorating instruments

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at fire sale prices into the market, just when demand evaporated. This contagion began to spread throughout the financial system, since all financial institutions holding MBS/CMO (and not just the hedge funds) similarly had to mark down the value of their holdings. With the market for these securities disappearing, it has become exceedingly difficult to determine their true value. Market participants proceeded to question the true value of the higher-quality MBS/CMO as well.

Mortgage availability has been cut back significantly, with most of the new financing going towards funding prime-quality, conventional mortgages that can be securitized and sold off to Fannie Mae and Freddie Mac. The result is a significant reduction in demand for houses, hurting all housing-related industries. With the equity in houses disappearing for the first time in several years, the negative effects have spilled over to consumer spending, which accounts for two-thirds of the economy.

The loss of appetite for riskier credits infected the private equity arena as well, the newly anointed financial "wunderkinds." During the months prior to market liquidity freezing up, Wall Street firms were eagerly committing massive amounts of their capital to funding the buy-out spree of the private equity firms, the new masters of the financial universe. They charged exorbitant fees to securitize these loans into collateralized loan obligations (CLO) and sold them off to buyers (again mainly hedge funds) hungry for high yields, leaving the Wall Street firms with money to finance deals all over again. These firms, in typical herd-like fashion, competed for this business, seemingly outdoing each other in terms of how liberal their loan terms were. Many of these loans contained either no operating covenants or only token ones (so-called "covenant-lite" loans), meaning the lenders were not requiring much in the way of business performance goals after the target companies were taken private. This was particularly risky, given that the targets would be servicing considerably more debt after being taken private, magnifying any slip up in performance.

As the risk appetite fell, potential buyers of these structured loans were no longer willing to accept the prevailing pricing or terms. They began to come to their senses and demanded heavy price discounts and more operating covenants, forcing the Wall Street firms to keep more loans on their own books. Some private equity deals are in trouble; others are in limbo. Since private equity firms were previously a prop for the stock market by acting as a source of ready funds to take public companies private, this declining trend in the fortunes of private equity firms contributed to the recent market correction.

The combination of all these adverse developments has raised the prospect of a recession in the next 12 months. Initially, the Fed responded by pumping massive liquidity into the markets; this money served as a very cheap source of financing to the banks, which was intended to encourage banks to lend and rebuild investor confidence.

There is now mounting evidence that the housing slump is adversely affecting consumer spending. While recently worrying out loud about possible inflationary pressures, the Federal Reserve made an abrupt U-turn and lowered both the fed funds rate and the discount rate by 0.50 percent at its September meeting.

Though this action was timely, the beneficial impact from the rate cut will not be immediate. The lower fed funds and discount rates will most directly affect loans based on short-term rates, such as those pegged to bank prime rates. These include credit card debt, home equity credit lines, and auto, personal and small business loans. However, the housing market will take time to work itself out, since fixed-rate mortgages are based primarily on 10-year Treasury rates, which have in fact moved up a tad because of remaining inflationary concerns. Many adjustable-rate mortgages are based on LIBOR (London Interbank Offered Rate), which is currently higher than the fed funds rate. However, the availability and cost of mortgages are not the only factors impacting the demand for houses.

Employment prospects, consumer confidence, and the overall debt picture for family households also greatly influence major purchases, like demand for houses. It is with respect to these factors that the recent lowering of the fed funds rate will have its biggest impact. With a steepening yield curve (see accompanying article), banks and other financial institutions should be able to make more money by borrowing short and lending long, which would increase liquidity and spur an economic recovery. This, in turn, should facilitate employment growth, resulting in more confidence, higher consumer spending and more willingness to make big purchases. Moreover, lower debt payments on certain types of loans will help the overall financial health of the consumer.

There is nascent evidence that some of the salutary effects of the rate drop have begun to work slowly through the markets, with some confidence and liquidity having been restored. For instance, the asset-based commercial paper market (the market where highly rated corporations borrow money on a short-term basis) is slowly normalizing. Several new junk bond issues were successfully brought to market recently, including over $1 billion by R.H. Donnelly Corp, suggesting more appetite for risk. The CLO financing the First Data Corp. deal was oversubscribed. And Countrywide, as the largest home mortgage originator in the country and the poster child of this housing and mortgage debacle, was recently able to tap another $12 billion to continue funding new mortgages.

With my expectation that the Fed will continue lowering rates in the months ahead, I remain optimistic that we can avoid a recession.

# Analyzing Short Interest as Contrarian Indicator

By Debbie Lee, *Senior Financial Advisor*

Here at PDV, we use many research tools to analyze investments before making a decision for our clients, including looking at the ***short interest*** in a stock. Short interest is the amount of shares sold short.

Selling short means selling shares that you do not own, usually by borrowing the shares from your broker. The shares eventually have to be returned, which means they have to be repurchased at some future date. An investor sells short if she expects the stock price to drop, allowing her to buy back the stock at a lower price and make a profit.

Because the broker determines when the shares have to be returned, the investor can be forced to repurchase at an inopportune time. Such would be the case if the stock price has gone up since the short sale, and the investor has to buy the stock back at a higher price, thereby incurring a loss.

Short interest is the total number of borrowed shares of the stock that has been sold but not repurchased. It is often expressed as a percentage, meaning the number of shorted shares divided by the number of outstanding shares.

Another useful metric is the ***short interest ratio***, which is obtained by dividing the total number of shares sold short by the stock's average daily trading volume. The average daily trading volume for a stock is the number of its shares traded each day, averaged over a specified rolling period. The short interest ratio is also referred to as the "***days-to-cover ratio***" since it gives the number of days to cover the short position or buy back the total number of shorted shares.

Most investors consider a rising short interest position to be a bearish sign. As a contrarian investor, here at PDV we see high short interest percentage or short interest ratio as a long-term positive, as all those shorted shares have to be "covered" or repurchased at some future date. This acts as a potential source of future demand for the stock. The most desirable outcome would be a "short squeeze," involving a rise in a heavily shorted stock, pressuring investors who are short shares to repurchase the stock to limit their losses. This demand drives the price up further, causing waves of buying from other investors who are short the stock and resulting in an upward spiral.

You should never invest in a company based solely on an analysis of the short interest and related ratios. However, it has a place in a wide arsenal of research tools for making informed investment decisions.

# What Bonds to Buy

By Louisa Ho, *Portfolio Analyst*

Now that the Fed has lowered both the fed funds and discount rate by 0.50%, what types of bonds look attractive? In the past few years, it has paid off to buy very short-term, high-quality bonds. With the recent interest rate drop, a change is in order. But to identify attractive bonds under current market conditions, it is necessary to discuss several basic concepts about the bond market first -- yield curves and credit spreads.

One common technique that fixed-income investors use in their decision-making process is analyzing yield curves. A yield curve is a graph that depicts the relationship between yields and maturities for bonds in a similar category. Generally speaking, the more risky a bond, the higher its yield needs to be to compensate investors. Since bonds with longer maturities subject investors to higher interest rate, inflationary and other economic risks, they typically offer higher yields than those with shorter maturities. Yield curves are therefore normally upward sloping.

The steepness of a yield curve depends on the differences in yields across various maturities. Yields generally move in the same direction as market interest rates, but inversely to bond prices. Short-term US interest rates are most directly influenced by the fed funds rate—the rate banks charge each other to borrow money overnight. Long-term interest rates are determined by the market rather than the fed funds rate, and respond most directly to inflationary expectations. Therefore, long-term rates do not necessarily fall in reaction to lower short-term rates. In fact, long-term rates have risen somewhat after the Fed cut short-term rates recently. The market pushed long-term rates up, fearing an accommodative Fed might stoke inflation, hurting long-term bond prices.

A yield curve can be created for any class of bonds, such as Treasury securities or BBB-rated corporate bonds. The Treasury yield curve, which plots the yield of Treasury securities against maturities from 3 months to 30 years, is widely used as a benchmark in the bond market, because U.S. Treasuries as a practical matter have no default risk. Since corporate bonds are subject to default risk, they offer higher yields than Treasury securities. This difference in yields between a given corporate bond and a Treasury security with comparable maturity is known as the "credit spread."

The size of the credit spread at any point in time depends on the specifics of the corporate bond issuer and overall bond market conditions. When the issuer is enjoying improving financials, its bond will typically go up in value, thereby narrowing the credit spread. Deteriorating financials usually mean the reverse is true. And when the market is risk-adverse, demand for default risk-free Treasuries will rise, widening credit spreads against all other bond classes (assuming all other factors are held constant).

When the credit spread is thin, it is less rewarding to invest in lower quality bonds. You are subjected to a higher default risk without being adequately compensated by a sufficient incremental yield. It is generally appropriate under these circumstances to stick with higher quality bonds.

Another important element to consider is the shape of the yield curve. It does not pay to buy long-term bonds when the yield curve is flat (like the past few years). You are subjected to greater interest rate risk, without being adequately compensated by a meaningful higher yield. But today, the yield curve is steepening, because short-term rates are dropping, while long-term rates are rising.

Under the current market conditions of a steepening yield curve and wider credit spreads, it is appropriate to shop among longer-term bonds with decent, but not necessarily the highest, credit ratings.

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