

Impressions

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Attack of the Imam!

Heaven opened then, indeed. The flash was almost too novel for its inexpressibly dangerous nature to be at once realized, and they could only comprehend the magnificence of its beauty. It sprang from east, west, north, south. It was a perfect dance of death. The forms of skeletons appeared in the air, shaped with blue fire for bones-dancing, leaping, striding, racing around, and mingling altogether in unparalleled confusion. With these were intertwined undulating snakes of green. Behind these was a broad mass of lesser light. Simultaneously came from every part of the tumbling sky what may be called a shout; since, though no shout ever came near it, it was more of the nature of a shout than of anything earthly. In the meantime, one of the grisly forms had alighted upon the point of Gabriel's rod to run invisibly down it, down the chain, and into the earth.

Far From the Madding Crowd by Thomas Hardy

This quote from Thomas Hardy has nothing to do with what I am going to talk about I just liked the great description of a huge electrical storm.

The Attack of the Imam

Join us now as we return to the exciting world of newsletter writing with masked man and his faithful word processor.

In my last newsletter I laid about me with fire and sword about what I see as the fate of Islam and the hypocrisy of its the treatment of women. This excited a number of comments included an attack on me by a local Imam.

The Iman is not on the mailing list for Impressions and neither is the fellow who first objected and who referred the Imam to me. So somehow a reader of this letter started the whole thing rolling.

These were not the only compliants on the newsletter. I recived a total of 16 emails all from people portored to be Muslim. Some of them may not have mastered the intricacies of the American system but they excel in colquial profanity.

All of the correspondants objected to my remarks that Islam was dying religion and culture and that the current unrest was its death throes. The Imam and his infomant were particularly concerned with my comments on the role of women in Islam. Apparently the dispute arises out of two Sura (chapters) of the Koran (or Q'urn if you wish) 2:187 and 4:34.

I am not going to bore you with a long repetition of my discussion with the

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Imam other than to say that he and I will continue to disagree.

In my humble opinion, the whole problem with the modern Islamic movement is a fundamental difference in doctrine. In the Islamic tradition, the Koran is the literal word of God. As such, it is not open to interpretation. After all, you can count on one hand the number of people who have argued with God and survived. In the Christian tradition, the Scriptures are divinely inspired but composed by humans.

The difference is the process of exegesis, or the critical interpretation of text. Islamists believe that constant interpretation and the potential changes it brings is the weakness of Christian faith. I believe it is the strength. To be a functional guide for living, any belief system must be relevant to its believers. Islam is increasingly relevant only to those who worship death.

The issue of women is more interesting. Women's role in society has certainly changed. One female role has transcended history. Women are the civilizers.

George Gilder, the high tech guru and futurist, once said that men come to civilization through a woman's womb. The disenfranchisement of women in the Islamic world combined with a cult worshipping death is Islam's Achilles heel.

If the youngest, most impassioned people in a society are voluntarily killing themselves and being celebrated, what does it say about the mores of the soci-

ety? If all the idealism of youth is directed to a false sense of paradise achieved only in death then the sparks of creativity will be extinguished.

It is no wonder that the society, which gave us our numbering system and modern astronomy, has produced nothing but killers and maniacs for the last 500 years.

The Markets and Risk

The press coverage lately about the horrors of the sub prime mortgage lending has focused some attention on the issue of risk and reward we raised in our last letter.

Everyone who read the letter agreed with me that the markets were offering inadequate compensation for risk. Conformity is scary and particularly if its conformity to my thinking. It was more frightening to find out that everyone believes there will be some credit adjustment in the future to remove the inconsistencies.

In the face of all this consensus of course, the stock market has hit new highs; a hedge fund went public and was up 18 points the first day. Junk bond spreads did not widen and structured product continued to roll off the assembly line.

The question being debated in the bars and dives haunted by Wall Streeters- sorry that doesn't happen any more. In the politically correct world of modern finance, everyone is too effete to go to bars. What I should have said was in the

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sweat-filled rooms of health clubs, over a Jamba Juice or two, the big discussion is will the sub prime blow up will kill the economy.

The answer is possibly. A recent survey revealed that real estate was 45% of the average homeowner's net worth and equities only 9%. The real estate in question is residential real estate mostly owner occupied homes.

The fact that homes are at this level of net worth contains a couple of very interesting paradoxes. First, your home is not an investment, never has been, never will be. I don't care if the price is supposedly going up 12% a month. You have to live somewhere. If you live in a toney suburb, you are unlikely to sell your house and move to the 'hood. If you sell your house, it is going to be to purchase another in a similar neighborhood. Guess what- at about the same price.

When a stock or tradable asset has a constant stream of buying it is said to have a good bid. Generally, a good bid means higher prices. The bid in houses was generated by cheap mortgage financing undertaken by lenders who believed they had no risk. The lender had no risk because they could sell the loans to an ever-hungry Wall Street for re-packaging into MBS (mortgage backed securities). That got the loan off the books and out of sight out of mind.

The financial community has some new players. It is no longer just the home of commercial, brokerage houses and in-

vestment managers. Those three horse-men are now joined by the hybrid fund. These latest additions are hungry.

I imparted a lesson about houses as investments now I will give you another. The big funds you hear about only care about making money in a secondary way. What they care about is bringing in assets so they can charge fees. How do they get more assets? They show returns that are eye-popping. How do they generate those returns? By finding and holding investments where they are the only arbiter of the value.

This brings us back to sub prime lending. The area of greatest risk for a mortgage lender is the first two years. In those years, there has been little appreciation so liquidation via foreclosure is a losing proposition.

Bankers do not want to repurchase loans and they do not want the property. So they restructure the loan, or make a new loan or forgive payments or something to make it look like it is performing.

Since the stock market crash of 2000 and lower interest rates, real estate has been all the rage. Everyone wanted to play even those who could not afford to. So if you are bank wishing to make a lot of loans that you are going to sell what do you care about quality?

However, you say, the buyers certainly cared. Not really because they got to determine the value and the interest rate was great. In addition, they tried to

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eliminate their risk with derivative transactions.

This provided the banks with entities with a steady appetite for higher yielding paper because it goosed returns and helped to bring in more assets.

You would think that someone would have blown the whistle at some point since the collapse had to be coming. Here is the third lesson. There was no one to blow the whistle because no one was going to kill the golden goose!

The lenders were not going to do anything since they had no risk and enjoyed the rising earnings generated by mortgage origination.

Wall Street was not going to do anything proactive to hurt earnings. Wall Street is like a kid with an eating disorder, it will eat until it barfs and then will eat more. Wall Street was making billions in packaging, trading and derivatives creation. Wall Street does not live in the future it lives in the present. The average trader or investment banker's horizon is from the present moment until partners are picked.

The government was not going to do anything. First, the would be regulators did not understand what was going on. Second, they enjoyed all the taxes they were getting. Third, there was no immediate way to blame it on the Bush Administration. The other angle was that the politicians were basking in the glory that they were helping people accomplish the American dream of home ownership.

Therefore, the hunger from financial engineers created a huge bid for mortgage paper regardless of quality. Seeing the demand, the lenders, seeking higher earnings, sought out less and less capable homebuyers. Homebuyers, driven by the falsity that their home was an investment took advantage of the cheap and available money to purchase homes and to finance a lifestyle.

I have reproduced on the next page a chart of showing sub prime mortgages as a percentage of total loans in 2006. Note particularly the black areas. Those are the locations with the highest percentage of sub prime loans. They are not coincidentally, the places with three other characteristics: high inbound immigration, loose controls on illegal immigration and high housing prices. However, you need to be aware of one fact, sub prime borrowers are no longer the guy who cuts your grass, a good number of them own pricey houses in good neighborhoods.

So what could happen? First a quiz. If two identical houses are valued at \$500,000 each and one has a mortgage of 350,000 and the other 450,000 and both the homeowners can't pay the mortgage. Which house does the bank foreclose on first? If you answered the one with a \$450,000 mortgage you are wrong, they will seize the one with most equity.

What they are likely to do with the homeowner with the large debt is to suspend payments, lower the interest rate, make a new loan or something to keep from going into foreclosure. Foreclosure is an expensive, risky and time-

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consuming legal process. On average, from the time of the foreclosure notice to the resale of the property is 14 months.

Here is another lesson, banks no longer make loans because you are good guy or gal, they do not make loans if they will have to sell the assets to come out whole. They make loans because it is profitable to do so and they do not want the property back. If you are in financial trouble, borrow all the money you can. If you can borrow enough the bank will work with you. Hey, it works for Donald Trump!

The banks who made the loan will try to get the borrower back on track so the first run through of sub prime loan problems will not be the last. Some of the borrowers will be okay but some will not. They will exhaust all the tricks and the house will be foreclosed.

In many, if not most cases, the purchasers of the MBS (mortgage-backed securities) containing the defaulted sub prime loan has the right to demand that the original lender repurchase the loan. This of course is exactly the opposite of what the lender wanted and it craters the lender's ability to make more loans.

Now for the final irony. Most of the sub prime lenders are not traditional banks. They do not take in deposits and make loans they are non-bank banks. What they are is production facilities who have a warehouse line of credit allowing them to make loans valued up to line limits.

They then sell the loans they are making and start all over.

So where do these lines of credit come from? Well in some cases, they come from traditional banks seeking greater loan production, in some cases, they come from hedge funds other pools of private capital but in most cases, the lines are produced by Wall Street firms. The Wall Streeters profit by making the line available, by structuring and selling the product and by trading it in the aftermarket. What a great business, profiting from the same money four times!

As history has shown, Wall Street is not going to blow the whistle on excess. They wallow in it. The only time Wall Street will cut off a borrower is if the Wall Street firm's profits are endangered.

That is why this got out of hand. There is no cop on the beat. Easy money and constant demand caused a lowering of the underwriting standards and that made the wheel go faster.

Could this unroll the economy? Yes. Will it? Not by itself but our economy is based on a fractional reserve system, which bets that not everyone will need their money at the same time. If some other crisis or combination of demands on the credit system occurs, there could be severe consequences. If you are a real estate vulture, keep your eyes open this might get very interesting.

BIG CHANGES

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As many of the readers of this letter know, I have run Sweetwater with a small staff for all the years it has been in existence. Due to the trust and confidence clients have placed in the firm, we have grown to the point where I needed make some changes.

There has been the problem of age. Although at age 60 I feel fine it is wise to provide our clients with a succession plan.

This does not mean that I am retiring or really even slowing down. Several clients have intervened with the Almighty to extend my life forever, so I expect to have the funeral home bag me and tag me right here in the office.

In one of those wonderful juxtapositions as I began to think about this a number of very talented, experienced and honest people I have known for a long time became available.

Some time in April Mike Baker, formerly Managing Director of Bear Stearns Fixed Income Department, will be joining the firm as an owner and partner.

I have known Mike for over 20 years and he has had a unique career. He holds a Coast Guard master's license for 1900-ton ships and has been a commercial fisherman all appropriate training to for the entrails filled world of bonds.

In addition, we are in active discussions with three other persons, one from the brokerage community and two who have a small investment management firm.

In making these moves, my first consideration has been to provide our clients with better service and I am convinced that you will be very pleased with the results.

Big Change II

As we go to print, the US District Court in Washington DC has overturned the so-called "Merrill Lynch Rule."

A brief history. Brokerage houses like Merrill, Morgan Stanley, Goldman, Smith Barney are regulated under the terms of the Securities Act of 1933. The Investment Advisors Act of 1940 controls firms like Sweetwater.

The two Acts impose very different rules of conduct. The 1933 Act requires that the agents of a brokerage firm must place the interest of the firm above those of the client. The 1940 act says that the only basis for action is in the client's best interest.

These differences were not important for many years. The activities of brokerage house were quite different from the fiduciaries of the world such as trust banks and financial advisors like Sweetwater.

In the last few years with the steady downward pressure on commissions, the brokerage firms have been offering a series of fee based services and marketing them as fiduciary based. Since this represented a direct conflict in regulatory scheme, the brokers went to the SEC and got them to enact the Merrill Lynch Rule.

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This rule or really exemption, allowed the brokers to offer fiduciary services without having to register and fall under the 1940 Act.

This was off course a sham since regardless of what representations made by the individual broker if push came to shove the client's interest would be secondary.

The Court's decision striking down the Merrill Lynch Rule is an earthquake. It means that each brokerage firm offering fee based or fiduciary services is going to have to register its brokers under the 1940 Act and they are going to have to supervise their activities to avoid censure and fine.

Many of the firms with internal investment management companies have those firms under 1940 Act control. This ruling means that each individual within a firm offering fee-based services will have to register. If they have less than \$25 million in assets, they each will have to register with the various states. This will be cost and administrative nightmare.

This is too complex a case for instant analytics but it is likely to have some wide-ranging effects. You can also expect that the industry is going to lean very hard on the SEC to do something in its favor.

Here is the bottom line for you. If you have accounts firms managed by an individual in the firm's brokerage side, they are not nor can they ever be your

fiduciary. They are bound by law to consider the interest of their firm first and yours second.

If you like your financial interests to be second fiddle to the people who gave you Enron and the sub prime mess then stay there. If not, this is a perfect time to assess your options.

Good Luck,

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