



NCM Client Alert

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To Our Valued Clients:

We are aware that the recent market volatility has probably caused some to become a bit alarmed. To be sure, dramatic market swings can be unnerving.

It is important that you understand the underpinnings of the current situation, Federal Reserve actions to cope and our best guess outcome.

CMO's and CDO's – What are they?

To begin, the problem lies in a type of investment referred to as CMO's (collateralized mortgage obligations) or CDO's (collateralized debt obligations). These are investment vehicles that pool mortgages (in this case) and sell off portions of the blended pool to investors, mutual funds, banks, hedge funds and other types of investors.

Crisis of Confidence

The diversification of these large pools across hundreds of mortgages would seem to protect investors from extreme losses. However, as the real estate market heated and lending standards became increasingly lax, the underwriting or qualifying of loans that went into these vehicles weakened. This is problematic for an investor who owns a portion of such a pool as they are uncertain about the credibility of the quality representations made when the pool was created.

Growing Defaults

Now throw into the mix an increase in sub prime and "Alt A" (one step out of sub-prime) mortgage delinquencies. It is important at this point to understand mortgage defaults are NOT the cause of the current market situation. Clearly, at some level there is a fear that borrowers with higher credit quality loans will begin to default on their mortgages, just like those in the sub prime market, and that this could trigger a recession or financial crisis. But at present, the actual defaults are not the problem.

Who is Impacted by Defaults?

It is also important to understand the current crisis is primarily rooted in greed.

Greed has manifested itself primarily through investment vehicles referred to as hedge funds. Hedge funds are accounts wealthy individuals often invest in. They are like mutual funds to a certain extent. People put their money in and a manager or managers apply their knowledge to investing those funds... hopefully at a profit. However, hedge funds are also very different than mutual funds in that they are virtually unregulated by the Securities Exchange Commission and importantly they do not tell the investors in the fund what strategies they are going to employ. In fact, they do not even disclose what they invest in. It could range from pork bellies to blue chip stocks. Finally and most destructive in the present downturn, hedge funds use leverage. Some funds have as much as ten times as much debt as equity (investor dollars).

To give you an example, using the leverage cited above a fund could have \$100 million worth of investor's dollars and \$900 million of borrowed funds. At that point, the hedge fund manager would have \$1 billion to invest. This amplifies profits ten-fold, but can cause collapse if the manager's bets go awry. Such bad bets were the first big crack in the CMO and CDO markets.

Again, citing the figures from above, if such a fund lost 5% then the “equity” or investor dollars would have plunged to only \$50 million. When this occurs the lending institutions who loaned money to the hedge fund get nervous and institute what is referred to as a margin call. This means the fund has to begin to sell off positions and deliver dollars to the lender. But if those securities are dropping in value AND the hedge fund adds to the decline by selling more securities the cycle can become vicious and the fund can collapse, as was the case with a couple of Bear Sterns funds recently. Further, if the selling becomes extreme enough as the hedge funds domino, the market in CDO’s and CMO’s can seize up.

At this point the question is really “why should we care”? We don’t use hedge funds and who cares if a bunch of rich people lost 100% of their investment.

The Problem

We should care because it is not only hedge funds that invest in CMO’s and CDO’s. Many financial institutions who do not use leverage invest in them as well, including mutual funds.

Businesses and funds are required to show the value of securities at the lower of original cost or market value. The market for CDO’s and CMO’s has seized up, making the valuation of such securities impossible to determine. This creates a big problem for a hedge or fund manager who has to honor investor redemption requests. If the market has seized up to the point they cannot reliably value the CMO/CDO’s, then what should they pay the redeeming shareholder. At the extreme, if a fund is heavily or exclusively invested in such vehicles, they may not be able to raise enough funds to satisfy redemption requests.

As a consequence of this very phenomenon the European Central Bank had reacted to French bank BNP Paribas SA’s decision to halt withdrawals from three investment funds because it couldn’t value its holdings. BNP Paribas blamed a “complete evaporation” of liquidity for the drastic step.

So you can see the real problem is one of confidence and not actual mortgage defaults. The collapse in confidence has caused the CDO/CMO market to seize up.

What Is Happening Now?

When a situation such as this arises, the Federal Reserve will intervene as it did today. They have a variety of tools at their disposal, but the initial one they chose to use is the most subtle. They “injected liquidity into the system”.

This means they pumped money into the financial markets (equally as vague). The way they chose to do this was by offering to purchase \$35 billion worth of CDO’s and CMO’s. This amount while seemingly large pales in comparison to the actions of the European Central Bank’s \$132 billion injection. Nonetheless, this will ultimately accomplish three things.

First, it created some confidence in the stock market that the Fed is on duty and ready to act.

Second, it took \$32 billion of the troubled vehicle out of the market and created some transactions in CDO/CMO’s.

Third, a byproduct of this crisis has been that short-term interest rates started to rise sharply. This is bad for the overall economy because it makes it more expensive for all of us to buy our lattes on our credit cards. By injecting the capital it brought those rates, known as the Fed Funds rate, back down to the 5.25% target the Fed wants to see.

Conclusion

Is this crisis over? Probably not. It is just too big to be done in a day.

However, recognize the Federal Reserve has all of the necessary tools to resolve the situation. They will use them in a calculating fashion because it is not their job to keep recklessly managed funds and institutions in business. This would reward them for taking risk, which ultimately is destructive to the overall economy and markets.

Nonetheless, they will also not allow this to tip us into recession or cause a stock market crash. Remember, we are still up for the year.

We are confident six months from now investors will look back, breathe a sigh of relief but recognize this for what it is... just another event with short-term implications for the stock market. Crises have occurred many times over my 24 years in the investment business. While we do not mean to minimize the risk, we must temper our emotions and view such events analytically.

We will remain diligent and do our best to keep you informed.

Jim et al