

The Market Cap



The Wall Street melt down and you
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Bankruptcies, bailouts, plunging indexes...what's next? From living rooms to water coolers, bus stops to the presidential campaign trail, everyone is talking about the market. These are tough and turbulent times on Wall Street – and on Main Street.

Savvy investors want to know not only “what went wrong?” but “what can I learn from these unprecedented, historic events?”

The root causes for the current financial crisis can be traced to several government related sources:

1. **Community Reinvestment Act (CRA), which requires banks to lend evenly throughout the communities in which they operate.** It is designed to eliminate selective lending practices. The act causes banks to increase the number of loans it makes to moderate and low income borrowers for home loans.
2. **Mark-to-market rule, FASB 157, which forces banks to value their assets to a current market price.** In a fractured and distressed market environment such as this, sound institutions are forced to mark down the value of assets based on a value derived by another institution, many of which were forced to sell assets aggressively to create emergency liquidity. Assets may have been sold at very cheap prices, which then must be recognized by all owners of similar securities. Thus a downward spiral is created.
3. **Elimination of the fixed leverage rule.** In 2004, the SEC abolished the net capital rule on bank capital for five investment banks (Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns) and replaced it with model-based leverage rules. This means that these five investment banks increased their leverage from about 10-12 times capital to an aggressive 30-40 times capital. Three of these firms are now gone.
4. **Duopoly (Fannie and Freddie) in the market for residential mortgage securitization.** The existence of Government sponsored enterprises artificially increased the amount of capital available to the housing markets well as artificially lowered the cost of that capital. Fannie and Freddie continued to buy terrible subprime mortgages because they were more concerned with the political risk of losing their status than the financial risk of buying subprime mortgages.

Who would have ever imagined Fannie Mae and Freddie Mac would be taken under government control? Merrill Lynch would have to be acquired? Lehman Brothers bankruptcy was the biggest in US history. The failures have been astonishing. But in order to get an accurate picture we need some perspective.

Here's what the magnitude of the situation means to you:

The Federal Reserve and Treasury back a \$700 billion dollar plan to buy distressed assets from troubled financial institutions. \$700 billion dollars is a lot of money. To put that dollar amount in perspective, note that total subprime mortgage lending totaled about \$1.3 trillion, and so-called Alt-A (reduced documentation) mortgage issuance was about \$1 trillion. The current market value of subprime loans is somewhat less than half of the face value, and the market value of Alt-A loans is perhaps 25% below face, so the outstanding market value of troubled mortgage assets comes to about \$1.4 trillion.

Under the current bailout proposal, the Treasury would buy mortgage-backed securities backed by subprime or Alt-A collateral at roughly 50 cents and 75 cents on the dollar, respectively; this is around where they currently trade.

No one suggests that the troubled securities are worthless; they are backed by residential real estate.

Although the bailout plan authorizes \$700 billion, the assets would eventually be sold to recoup most of the expense. If we assume a worst-case scenario in which the Treasury might overpay for mortgage-backed securities and other structured products by 25%, the net increase in government debt would be 25% of \$700 billion, or \$175 billion. In this case, the Treasury would deliberately overpay for securities held by financial institutions in order to protect their solvency. Because financial institutions are highly leveraged, few points of dollar price separate an insolvent institution from a healthy one. An investment bank holding \$25 of securities for every \$1 of capital, for example, would become insolvent if its portfolio value were marked down by more than 4%. That in essence is what brought down Lehman Brothers and Bear Stearns.

Even in the worst-case scenario where \$175 billion may be lost, the US debt-to-equity ratio will not increase significantly. In addition, if all of the \$175 billion were realized as losses, the losses would occur over a period of several years. In practice, the worst-case scenario is unlikely even under the most extreme circumstances. It would be difficult for the Treasury to massively overpay for assets without drawing critical attention.

The Issue for Investors

Understanding how we got here is important for regulators to prevent this from every happening again. For investors, there is a more important lesson and it is nothing new. Investors must recognize the role of human nature in how financial crises arise.

Many commentators would include greed as source, perhaps the primary source, of the current crisis. There is, of course, an underlying desire for “more” in all of us: more money, more things, more security, etc. The desire for more is ever-present and it inspires all sorts of good – like new technology, better goods and more efficient services (including innovative financial services). Sometimes financial goes too far too fast. In the current case, most people didn’t understand the risks associated with Collateralized debt obligations (CDO).

The bottom line for individual investors is that it is unrealistic to think that you can foresee specific business failures and financial crises. If industry experts can’t foresee the crisis, it’s virtually impossible for the rest of us. If equity analysts like Henry Blodgett didn’t predict the internet bubble... if federal regulators couldn’t foresee the S&L crisis 20 years ago... if currency experts couldn’t protect against the devaluation of the Thai Baht in 1997 or the Russian Ruble in 1998... how can anyone be expected to defend against financial harm?

Fortunately, individual investors don’t need to predict market crises to be successful investors. We do, however, need to acknowledge and understand the nature of markets and the nature of the people who make up those markets. Over the course of each of our investment lifetimes, it is not a question of if we will experience market turmoil it is a question of when turmoil will hit and a question of whether or not we have an allocation (and the personal discipline) that enables us to ride out the storm.

Some experts believe we are near an end to the bad news in the current crisis. Even the most pessimistic analysts acknowledge that in a couple of years we will have weathered today’s problems and there will be no lasting detriment to the economy. Financial history has made clear that “expertise” in finance has nothing to do with being able to predict or avoid rare and consequential events. Unprecedented financial events happen all the time. Plan for and expect them.

Those who fail to plan for and “expect the unexpected” are always at a disadvantage.

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