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Street yields to 'when ducks quack, you feed them'

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PERSONAL FINANCE

Interest rates have decreased dramatically through the years, and interest-rate spreads between high-grade and low-grade instruments have narrowed significantly.

Investors — both institutions and individuals — have clamored for more yield, and Wall Street obliged. After all, the old adage, "When the ducks quack, you feed them," has been the Wall Street rallying cry for years.

Consequently, after years of raking in gigantic fees to create and distribute mortgage-backed structured products to their clients, some of the largest brokerage firms and banks are taking huge write¬downs. Merrill Lynch, Citigroup, JPMorgan Chase, Credit Suisse, Bank of America, Goldman Sachs and Morgan Stanley all have been involved in the subprime debacle by structuring and distributing products, and by holding the paper on their balance sheets.

The blow to shareholder wealth in the financial sector has been staggering. In addition, a number of state government liquidity funds, bond funds and even money-market funds have suffered losses by buying "high quality and investment grade" commercial paper, only to see some of these notes severely downgraded and become illiquid.

Mortgages are typically less predictable than bonds. Prepayments and payment collections make each mortgage unique. Wall Street firms take bundles of mortgages and transform them into securities that are sliced into a number of "tranches" and sold to investors as Collateralized Debt Obligations (CDOs).

Each CDO tranche has different risk and return characteristics, thereby providing investors with more predictability than a whole mortgage pool. The lowest-quality junior tranches withstand the majority of the defaults and delinquencies in the pool in exchange for generating much higher interest rates. Conversely, the highest-quality and most senior tranches generate a much lower rate and receive the majority of the principal repayments from home sales and refinancing.

Wall Street firms pay rating agencies (primarily Moody's and Standard & Poor's) to evaluate and "rate" the CDOs. The higher the rating, the larger the market of investors and the easier the CDOs are to sell.

In a typical offering of the last couple of years, 80 percent of CDOs' tranches were rated AAA, the same rating as U.S. Treasuries. The remaining 20 percent were expected to absorb any losses from the underlying pools from delinquencies and foreclosures in exchange for much higher rates.

Both Wall Street and the rating agencies were dreadfully wrong. Not only did the lower 20 percent suffer severe losses, but even the former AAA tranches were severely down graded, and prices were punished.

Critics of the rating agencies argue that a huge conflict of interest exists. The rating agencies make large fees from rating CDOs and are sensitive to angering the issuers who pay these fees. When questioned about their ratings, the agencies waved the "freedom of speech" flag.

According to a recent Barron's article, "Former Clinton Secretary of Labor Robert Reich writes in his blog that the system is tantamount to movie studios hiring critics to review their films and paying them only 'if their reviews are positive enough to get lots of people to see the movie!'" While Reich's remark may be an exaggeration, you get the point.

Fortune Magazine wrote an exposé on a Goldman Sachs mortgage product, GSAMP Trust 2006-53, which was assembled in spring 2006. The average loan-to-value was 99.29 percent (only 0.71 percent in equity!), 58 percent of the loans were no-documentation or low documentation, almost all originated in California, and all the loans were second mortgages.

Sound risky? Goldman sliced the trust into 13 tranches, and Moody's and Standard & Poor's rated 68 percent of the issue AAA (just like a Treasury note) and 93 percent of the trust investment grade.

But by February 2007, the rating agencies had downgraded the top-rated tranches from AAA to BBB, and, by September, 18 percent of all the loans had defaulted.

A Dec. 27, 2007, Wall Street Journal article painted a similar picture about the Merrill Lynch "Norma CDOI, Ltd." Norma had 75 percent of its securities rated AAA in March 2007, only to see them downgraded to "junk" in November.

What are the lessons for investors, individuals and institutions alike?

- Rearview investing doesn't work. Rating agencies failed to look forward to the potential consequences of poor loan-to-value ratios, lousy documentation, a potential housing bubble (hasn't the frothy housing market been questioned by most analysts the last couple of years?), rising short-term interest rates and poor geographic diversification.
- Question the "access to deals" pitch made by Wall Street firms, big banks and advisers. Always review investment alternatives and understand the impact from a total portfolio perspective.
- Understand that brokers and investment advisers may try to hook you up with their own clients, such as money managers. This is a conflict of interest.

That's because the money manager may be buying research, accounting, trading and specific products from the broker-adviser, and that will taint the latter's opinions in favor of the money manager.

- Be wary of proprietary products. Although outside products may be available, proprietary products are almost always more profitable to the firm — and often the firm's adviser.
- Think diversification. Understand your portfolio's concentrations and focus on diluting excess risk. It's amazing how often investors take gigantic risks without understanding the limited upside potential.

Wall Street will always feed its ducks. But the ducks need to understand what they're eating.

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