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Well, well. Once again we've been seeing in the news that some "hedge" fund managers are not so smart. A couple of big hedge funds on Wall Street are in trouble, because they bought big portfolios of sub-prime mortgage pools using leverage. Now, first it is important to note that the word "hedge" used to mean reducing your risk, as in "hedge your bets." However, some of these "hedge" funds don't do that at all; instead they add more risk buying very risky assets using leverage, i.e. using borrowed money. So, I always look under the hood of hedge funds to see if they really are hedging their bets.



The description "sub-prime" for these mortgages is an understatement if I ever saw one. These are mortgages with little, no, or negative principal required from the borrower. I would call that "sub-sub-prime." In effect, they are a bet on the part of the lender that house prices will rise, creating principal, and thereby reducing the risk of the loan. We heard that house prices had been red hot and were poised for a correction quite a while ago, and we all know that the Federal Reserve started hiking interest rates in June of 2004, stopping at 5.25% a year ago. Consequently, we saw home building start to fall in the summer of 2005 and house prices turn down a bit later. And, we started hearing about the sub-prime mortgage problems early this year. Now, I am intimately familiar with the problems associated with hindsight investment criticism, but with all this information in hand some time ago, what on earth were these hedge fund managers, their investors and lenders (some usually astute financial firms) thinking? Staying with highly levered bets on very risky mortgage loan pools with ample negative information well in hand looks pretty silly to me.

So, what does this situation mean for the broader credit markets? In my opinion, not much. Sub-prime mortgages are a small part of the total mortgage market, and I do not see a widening impact on other mortgage pools where borrowers have made significant down payments. There may be some volatility if other hedge funds reduce their leverage and sell assets, but I do not see fundamental linkage to high yield company debt or REIT's. Nor do I see linkage to the broad stock and bond markets. So, while I am watching these developments closely, I do not see the need for portfolio repositioning over this issue. What we have here is another example of the U.S. capital markets taking a bunch of silly and/or greedy portfolio managers, investors, and lenders out to the woodshed. And that is a good thing that maintains discipline in credit markets. As always, please call me with any questions or concerns.

Sincerely,

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