

THE WEALTH PRESERVER

Second Quarter, 2003

Published June 14, 2003

Does the Fed's Policy Really Work?

In May 2003, two Senior Economists from the Federal Reserve Bank of Dallas published, "Monetary Policy in a Zero-Interest-Rate Economy." **Their article basically points out that many of the tools of the Federal Reserve to fight an economic downturn lose their strength as interest rates approach zero.**

According to the article, the basic problem the Fed runs into is that once rates are at zero people are indifferent between putting money in the bank or under a mattress. Keeping cash under the mattress is better than paying the bank to keep your money if interest rates are negative. Thus, the Fed cannot create money through the banking system. **They conclude that cutting rates is ineffective in bringing back the economy when rates are near zero.**

An interesting quote from the article that bolsters our forecasts and positions was **"Since August [2002], however, the incipient recovery hasn't unfolded according to plan [i.e. it hasn't recovered]. Employment has been particularly weak, hitting new cyclical lows for three months running."** An associated footnote points out, **"The year-to-year change in private payrolls has been negative for 22 straight months - the longest uninterrupted stretch of job losses since 1944-46."**

Reflecting on the facts that they present, I ask, "What about the last 11 interest rate cuts, and, the economy is still fading?" - I also like to point out that lowering interest rates did not work in Japan either. **Thus, I conclude that cutting rates is also pretty ineffective when rates are higher.**

Our position is that the Fed's policies for creating liquidity and growth "work" in a Bull Market when people are optimistic and fail in a Bear Market when people are pessimistic. Of course, we would have growth in a Bull Market anyway. All the Fed does is exacerbate the natural economic cycles.

Freddie Mac, Fannie Mae & the Apex of the Real Estate Cycle

In the 1st qtr 2002 THE WEALTH PRESERVER article, "Real Estate Subsidy Problems?" we asked the question, **"What would happen to housing prices if single family housing lost its government subsidy?"** We said, "Unfortunately, we might find out shortly." In that article we highlighted the "quasi government" housing agencies, Freddy Mac ("FRE"-NYSE) and Fannie Mae ("FNM"-NYSE) - **how they had been the major source of home financing for the past forty years and how they were leveraged up to the moon, even more than banks** (not even including the hundreds of billions of dollars off balance sheet derivatives they had). We also pointed out **the "counter-party risk" of their derivative portfolios** - that although the hedges might work out perfectly in theory, if the counter parties to the derivative hedges fail, the hedge will also fail in real time.

A Cover Up? - You probably are aware that Freddie Mac (and Fannie Mae by proximity) are in the spotlight. On June 9th, Freddie Mac fired its President for failing to cooperate with outside lawyers hired to probe its accounting. Freddie's CEO and CFO were also forced to resign. Authorities have tried to down play the situation by claiming that the result of their inquiry is that three years of earnings were somewhat understated. What makes me uneasy about this highly leveraged company and industry is that **if it were just that the "earnings were just somewhat understated for three years," why did they fire anyone?** Also, I thought maybe it was a personality clash - but that

would not result in firing more than one person. The stocks of Freddie and Fannie have fallen rather dramatically indicating that many feel "where there is smoke there is fire" and "shoot first, ask questions later." Even so, many professional equity portfolio managers and underwriters and regulators seem very complacent, even claiming that the recent scrutiny is "a positive." Unfortunately, we think it is most likely the proverbial "tip of the iceberg".

Valuation Problems? - Freddie's and Fannie's derivatives are of the most dangerous kind. **They are "over-the-counter" derivatives** - they do not trade on an exchange. Thus, they must be "evaluated" by someone rather than knowing what the market values them at. This situation is similar to the junk bond taxable market where I was an analyst for four years and a portfolio manager for eight years. When I was a manager in this category, mostly the "evaluations" were based on actual trades; if no trades were made within a recent period, the valuations were based on the mean between the bid and the asked (which might be as wide as ten points); if there was no bid, the portfolio manager (me) had to write up an evaluation report supporting the particular valuation level that he thought was appropriate. These memo's and the accompanying valuations, were reviewed and approved by the Board of Directors of the mutual fund on a quarterly basis. Importantly, mutual funds are generally restricted to not being more than 15% invested in such "illiquid" securities.

Just thinking about it, if the Freddie and Fannie derivatives were valued "correctly" and the mean between the bid and the ask widened out 10

More Inside...from Clark Stamper

Failed Hedge Ratios Reviewed
New Bull Market?

Continued on the inside back cover...

Failed Hedge Ratios Reviewed

Identical to risk-controlled arbitrage blow up of the middle 1980's
Similar to the mortgaged back derivatives collapse of the early 1990's
Similar to Long Term Capital Management's Demise in the early 1990's
Freddie Mac has likely experienced failing "Hedge Ratios"

A "hedge ratio" is roughly defined as "the number of futures, options or bonds bought or sold against a position in the underlying security in order to hedge the position."

Hedge ratios are a classic phenomenon of economics and/or economic modeling. They work adequately for a period of time and/or over a period economic movement(s); however, after large movements, they usually must be rebalanced (if they can) otherwise they fail.

In the middle 1980's I witnessed the first major failure in hedge ratios in recent financial history. The major investment bankers (such as Goldman Sachs, Merrill Lynch, etc.) had hired the top finance professors to help their clients "create value" in the new mortgaged backed securities market. Mortgaged backed securities are bonds that are backed by pools of mortgages on single family houses. The key distinction with mortgaged backed securities versus other bonds is that they can be prepaid at par if an underlying borrower pays off their mortgage.

One method of "creating value" was to get a financial institution (a Savings & Loan, for instance) to purchase mortgaged backed securities; use those mortgaged backed securities as collateral to borrow and purchase more mortgaged backed securities - basically "levering up the portfolio." You "couldn't miss" because you could borrow at a lower cost than what you were earning on the investment/collateral. However, there was some risk if interest rates went up or down related to prepayments of the mortgages. The financial "rocket scientists" solved this problem by helping the financial institution use the futures market to hedge away the interest rate risk and the prepayment risk. The entire scheme was called "**Risk-Controlled Arbitrage**" - arbitrage but with some risk that is controlled. The rocket scientists "proved" that it worked by running models with interest rates going up 3 percentage points and down 3 percentage points (rates at that time were around 10%) - they even gave us their "flip charts."

Risk-controlled arbitrage worked great for a year or so. The financial institutions who "invested" in Risk-Controlled Arbitrage racked up all sorts of "risk-free" profits. We weren't feeling too smart about it where I worked because we had decided not to pursue risk-controlled arbitrage - we didn't trust the investment bankers' flip charts and it seemed too good to be true. **Then, interest rates dropped dramatically and risk-controlled arbitrage bankrupted several Savings & Loans.** Luckily, as that was happening, I was able to attend a generic mortgaged backed securities seminar which featured the most renown financial "rocket scientists," many who had jumped to Wall Street after publishing the most well know finance text books. Anyway, **these famous "rocket scientist" from most of the major investment bankers got up on stage one by one and over the next two days each of them explained that "prepayments had SPED UP more than they had expected and the hedge ratio had failed."**

Fast forward to 1993. At the time I was managing two mortgaged backed securities mutual funds (in addition to a high yield bond fund and my muni fund). Around this period of time the investment bankers and their rocket scientists sliced and diced mortgaged backed securities a bit differently and came up with "inverse floaters" which would perform exceptionally well if interest rates dropped compared to normal mortgaged backed securities. The "inverse part" was that if rates dropped, the coupon on the inverse floater rose. However, if interest rates rose dramatically, inverse floaters would extend as people would not be refinancing their mortgages and (here is the inverse part again) the coupon would be zero) - so you could end up with a long zero coupon bond and the price would drop dramatically - but **no one expected that to happen.**

Because of my close encounter with risk-controlled arbitrage, when I analyzed mortgaged backed securities, I modeled them all the way to the absolute best case and all the way to the absolute worst case - interest rates up 10 percentage points or down to zero and prepayments down to zero and as fast as possible. Most of the brokers calling on me could not believe I modeled the bonds so extremely. Then, well, probably some of you remember 1994, the worst bond market since 1937 (here is a plug, in 1994 my muni Fund was number one out of all 800 muni funds!) happened. **Rates rose dramatically, and prepayments SLOWED DOWN more than anyone expected.** Bonds that some portfolio managers put in money market mutual funds extended from less than one year out to thirty years and dropped precipitously in price. Some money market mutual funds broke the "buck" (but most were bailed out by the mutual fund's parent). Orange County, California almost went bankrupt because of its "derivative" mortgaged backed securities. Now that example was not really "hedge ratios" failing but it was **essentially the same idea - the market moving outside the bounds for which some sophisticated investment scheme would continue to work properly.**

It was around this time that the hedge firm Long Term Capital Management had its "hedge ratios" fail, although in a different way. Long Term Capital was formed by several "rocket scientists" - this time they owned the firm and operated the hedge fund themselves (as opposed to selling scheme and securities to the client).

Continued on next page...

Related Question - **What "can't miss" industry has recently been financed with more and more debt, creating rising asset prices which in no current way are supported by the cashflow they give off (or save the owner/user)?** If you don't know the answer, please refer to the 4th quarter 2001 THE WEALTH PRE-SERVER article, "Real Estate - Overvalued?" where we explain it with a straight forward example.



points (10%) and the firm has a debt ratio of over 95% - it could mean, if the firm were forced to sell, it would have zero equity!!!! Of course, that is assuming the derivatives are valued correctly in the first place. **Now, there is most likely tremendous pressure on executive management to not value its assets downward** (especially if the firm is completely over-leveraged) because it would impair the firm's capital (and maybe their jobs). It would probably be **easier to succumb to that pressure if the securities were not exchange traded, but were traded "over-the-counter."** The temptation would be even greater if the securities were overly complex and the oversight was lax.

Failed Hedge Ratios? - I could see a situation at Freddie and Fannie whereby the hedge ratios went out of their normal bands (as interest rates dropped dramatically more than anyone foresaw because they continually thought the economy was going to recover but it didn't) and **realistic valuations changed dramatically** (see "Failed Hedge Ratios Reviewed" in this issue) **however, "accounting" valuations hardly budged.** Accordingly, **I find it highly probable that Freddie Mac's hedge ratios have failed and that, if its securities are correctly and realistically marked to market, that given its high percentage debt capitalization, it is bankrupt** (i.e. it has more liabilities than assets). Furthermore, with Freddie Mac out of commission, the value of mortgages in general will drop due to lesser demand and mortgage interest rates will rise. If Freddie had to sell assets, the problem of dropping asset prices would be even worse - it would be self-reinforcing - this time in the negative direction. This drop in valuation would exacerbate Freddie's problems - **it probably signals the end of the self-reinforcing cycle of mortgage financing getting cheaper and cheaper (and housing prices going up and up).** It is highly likely that Fannie Mae has similar problems but even if it does not, **the demise of Freddie Mac and the accompanying rise in mortgage rates and decline in housing values would almost certainly impair the over-leveraged Fannie Mae (along with many other financial institutions) whether they had problems previously or not.**

Failed Hedge Ratios Reviewed

(continued from page 2)

Originally, they performed their arbitrage magic on mortgaged backed securities. Later, they applied essentially similar modeling but this time including corporate junk bonds (remember I was a junk bond analyst from 1987 to 1990 and a junk bond portfolio manager from 1990 to 1998). I am sure everything was great for a while and they and their clients were probably giddy at the profits they were "booking." With that success they levered their investment vehicle up even more. I'm sure they monitored it closely including the prices the junk bonds were "trading at." However, when interest rates rose in 1994 and bonds in general dropped in price, there was also a drop in the stock market and in the market for high yield, junk bonds. Apparently, the fellows at Long Term Capital had planned on selling the junk bonds as a way of rebalancing their hedge (that probably worked for them with mortgaged backed securities).

"Uh Oh," they did not understand the junk bond market very well, probably because they had not been in that market through an entire down/up cycle. **The problem they were unaware of and their model did not capture was that of "liquidity."** When times are good the actual prices junk bonds can be bought and sold at are on average within a point or so of where they are evaluated (for example, if the evaluation is at 95, you could purchase them at 96 and sell at 94, for a spread of two points). But when times

are rough, the spread widens, often dramatically, and if you have size (big positions as Long Term Capital had) to go, you might not be able to get a bid!!!! Thus, **the liquidity of junk bonds dried up faster than the modelers had any idea about and resulted in Long Term Capital being unable to rebalance their portfolio and their hedge ratios failed.**

Another Self-Reinforcing Cycle (similar to those detailed in our 4th quarter THE WEATH PRESERVER article, "Self-Reinforcing Cycles") - Importantly, in hindsight, the creation and implementation of these different schemes took those markets to higher levels than would have occurred had they never been implemented. I can remember in 1993, thinking **who is buying this junk (bonds) at those levels absurdly high levels - it was junk bond newcomer Long Term Capital Management.**

In all three examples given here, it is important to note that **the assets were used as collateral to borrow to buy more of the SAME ASSET** as the program was implemented; thus, creating artificial and unsustainable demand that eventually pushed prices up to absurd levels that had to be retraced. As with all self-reinforcing cycles a limit was finally reached and it had to be unwound. **These are excellent examples of how unsustainable credit (that is borrowing or debt financing) financed bubbles are.**

New Bull Market? No, just more Bull from the Media

- 1). **The U.S. economy (and the rest of the world) is now clearly in deflation** (see 4th Quarter 2001 WEALTH PRESERVER article, "Deflation - The Unspoken Watch Word of the New Decade" and, again, last quarter in "Deflation - Confirming Evidence is in - The Last Holdouts Turn".)
- 2). **The equity markets are still trading dramatically above fair value** (see January 2001 MONTHLY MISER article, "Money Magazine Predicts Dow Jones Plunge").
- 3). **The mal-investments and accompanying debt loads of the economic & stock bubble have yet to work themselves out** (see 1st Quarter of 2003, "It is Not The War [stupid] - It's the Business Cycle:").
- 4). **The States of the U.S. must address their more than \$100 billion in budget deficits by balancing their budgets by June 30th.**
- 5). **We believe the announcement of the Freddie Mac scandal at this point in a counter-trend rebound is classic for resumption of the downward trend in the financial markets.** If the Freddie Mac situation is anything worse than already reported, we believe the markets are toast.
- 6). The market media is almost always wrong and **the current stock market rebound is at a typical percentage for a counter-trend rally in a Bear Market of this size.**



Our Fund Performance

Stamper Capital & Investments, Inc. has managed the Evergreen High Income Municipal Bond Fund since June 1990. The \$1 billion fund has been repeatedly recognized by Morningstar as a top-performer among its class, with the highest ratings in the overall and three-year periods. Stamper Capital & Investments, Inc. is a Registered Investment Adviser that specializes in the municipal bond market and is dedicated to helping investors earn the maximum return per the amount of risk taken. **Check out our website at www.risk-adjusted.com to find out more about how our strategies can reduce your overall portfolio risk, while maintaining equity-sized returns!**

Short-Term Municipal Bond Fund Category, Morningstar Rankings

Period As of 5-31-03	E.H.I.M.B.F.* Rank	Number of Competitors	Category Average Total Return	E.H.I.M.B.F. Tax-Free Total Returns	Pre-Tax Equivalent Total Return ¹	Morningstar Ratings ² (5 stars possible)	Percentage Ranking
1 Year	64	92	5.27%	4.14%	6.37%	★★★★	Top 32.5%
3 Years	29	81	5.89%	6.42%	9.88%	★★★★	Top 32.5%
5 Years	44	72	4.39%	4.21%	6.48%	★★★★	Top 32.5%
10 Years **	16	28	4.56%	4.52%	6.95%	★★★★	Top 32.5%
Overall	-	-	-	-	-	★★★★	Top 32.5%

*E.H.I.M.B.F. = Evergreen High Income Municipal Bond Fund, subadvised by Stamper Capital & Investments, Inc.

** Results from the B shares. A share estimate: 4.52 + .75 basis points = 5.27% or 8.11% pre-tax equivalent

The above chart summarizes the performance of our mutual fund client. We also offer Private Account Management with different strategies and greater opportunities to earn higher yields. **To give you an idea of the types of strategies available and the potentials offered through our Private Account Management, be sure to check out our website at: www.risk-adjusted.com.**

Stamper Capital & Investments, Inc.

1011 41st Ave., Suite A
Santa Cruz, CA 95062
888-206-6295

Disclaimer: Prior Performance achievements are not necessarily an indication of future performance. In other words, past performance does not guarantee future results. There are many types of risks and returns, and the trade-offs among them can result in different positive or negative returns depending upon the subtleties of the specific credit and security characteristics.

1. The pre-tax equivalent total returns are figured based on the highest Federal income tax bracket of 35%, no state taxes were included in the calculation.
2. Morningstar's proprietary ratings reflect historical risk-adjusted performance within a narrow investment category. Morningstar calculates a Morningstar Rating based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance, including the effects of sales charges, loads and redemption fees, placing more emphasis on downward variations and rewarding consistent performance. The ratings are subject to change every month. Morningstar ratings are calculated from the fund's three-, five- and ten- year (or life of fund, which ever is shorter) average annual returns in excess of 90-day U.S. Treasury Bill returns (on a monthly basis) with appropriate fee and tax adjustments and a risk factor that reflects the fund performance below 90-day T-bill returns (on a monthly basis). The top 10% of the funds in each category receive the highest a rating of five stars. The next 22.5% receive four stars, the next 35% receive three stars, the next 22.5% receive two stars, and the final 10% receive one star. Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.