

September, 2007

Dear clients and friends,

The money's not here ... Your money's in Joe's house, right next to yours. And in the Kennedy House, and Mrs. Macklin's house, and, and a hundred others. Why, you're lending them the money to build, and then, they're going to pay it back to you as best they can. Now what are you going to do? Foreclose on them? - A scene from "It's a Wonderful Life"

We thought we'd take a moment to explain why "subprime" mortgages matter to people with prime credit scores, why articles about hedge funds are so often in the financial news of late, why a large bank in the UK has its depositors queued up to withdraw their money, why the stock market has been so volatile recently, and why we still want to kick Alan Greenspan though he's no longer head of the Federal Reserve. Seems like a lot of explaining, but fortunately for us those topics are interrelated. (We'll oversimplify anyway, for the sake of brevity.)

Let's start with **mortgages**. As you know, most folks buy their homes with a 20% down payment, and their bank funds the other 80% with a mortgage loan. In the good old days in which *It's A Wonderful Life* was set, the bank's money came from its depositors. If a home buyer couldn't make his or her mortgage payment, the depositors shared the risk of not getting their money back. In the worst-case scenario where many home buyers fell behind on their payments and depositors asked for their money, the bank could fail.

Nowadays, the big banks get their money not from depositors, but by packaging their mortgage loans together and selling them off to investors, a process called *securitization*. Here's where the **hedge funds** come in, along with foreign banks, the Chinese government, etc. – they are the cash-flush investors eager to buy these securitized mortgages. The risks are highly concentrated, as these packages are sliced, diced, divided and subdivided so that each investor can choose the type of risk for which he or she has appetite, from top-grade prime cuts to those less-than-savory morsels that are, well, *subprime*. And as long as the people with the money were eager to lend it out, they did – even to those who probably shouldn't have qualified for loans.

We need to introduce a key character to the story; his name is **Leverage**. Consider our typical homebuyer, the one who puts 20% down, or 1/5th of the overall purchase price. Flip the 1 and 5 in that ratio, and we can say that the homebuyer has **5-to-1 leverage**. With 5-to-1 leverage, a 10% rise in the price of the house means a 50% increase in the homeowner's equity. That's the power of leverage, akin to buying stocks on margin. What if home prices drop? It would take a full 20% decline in the same home's price before the homeowner needed to worry about losing all of his or her down payment. Such declines are reasonably rare in the housing market, thankfully.

In fact, during the period 2000 to 2006, life was wonderful for homeowners, banks, and the hedge funds who invested in mortgages. Home prices were going up, defaults were going down, and hedge funds were taking in cash more quickly than they could spend it. With such easy access to capital, the banks relaxed their underwriting standards, *and began offering loans to borrowers that shouldn't have otherwise gotten them*, with only 5% down (or none at all!), and little to no documentation (You say you've got an income? Good enough!) The subprime lending business boomed.

Now, with only 5% down, a homeowner's leverage jumps to **20-to-1**, so that a 10% rise in home prices gives the buyer a remarkable 200% jump in equity. With money so easy to come by, and home prices being bid up, it's easy to see how a bubble might form. And form it did! Here's why: the hedge funds, foreign banks, etc. who were funding the mortgages also borrowed, and **they borrowed heavily, to invest in the housing market** - especially the subprime space. Some of them apparently had 5-to-1 or even 20-to-1 leverage too, like our homebuyers. Leverage upon leverage! And the stage was set ...

Spring forward to mid-2007. A handful of people with less-than-stellar credit histories found they couldn't make their loan payments. These folks had been tricked by **Alan Greenspan** who, years earlier, encouraged homebuyers to take out variable-rate loans just as he was beginning to raise interest rates. Now that rates had risen four full percentage points, these borrowers suddenly couldn't pay, and the default rates on subprime mortgages crept up, *just slightly*. But

enough to knock a percent or two off the value of the securitized subprime mortgage packages the hedge funds had purchased.

Remember how much leverage the hedge funds themselves had. Unlike the homeowner who may not have to sell the home that has declined in price, the hedge funds do have to report the value of their assets, to their investors and to their lenders. That seemingly small decline in the value of subprime mortgages spurred the margin clerks at the big **investment banks** (new character: those are the guys who loaned the money to the hedge funds to loan to the regular banks to loan to the homebuyers – whew!) to pick up the phone and demand more capital. So how does a hedge fund raise more cash in a hurry? It sells what it can – mortgages, *stocks*, bonds, etc. That selling begets more selling, and suddenly the hedge fund and many of its peers are down 5% in a week or two. Now, when you're a hedge fund levered 20-to-1 and you lose 5%, **the fund's entire equity is wiped out**. The only way to get more capital is to keep selling assets, even those that are entirely unrelated to the subprime market.

“Old man Potter'll pay fifty cents on the dollar for every share you got! Better half than nothing!”

And that's the problem we've had with the stock market in recent months. Hedge funds and other large investors have been driving stock prices lower as they trip over each other trying to raise cash they can no longer get from investment banks. In turn, traditional banks have lost a funding source and have cut back on their lending activities. The financial sector went from having too much capital to having no access to capital, almost overnight. The subprime, no-doc lending business is dead, and even everyday mortgages for creditworthy borrowers are now more expensive. Hedge funds and other investors, notably large foreign banks who also chased mortgages, have reported large losses. And just this week we witnessed the **failure of one of Britain's largest banks**, shot down by our antagonist Leverage who didn't like their excessive exposure to bad mortgages. (Well, it would have been a failure if the Bank of England hadn't stepped in with an unconditional guarantee of all deposits. Does the phrase “moral hazard” mean anything anymore?)

We have commented before on the possibility that the Federal Reserve wouldn't stop raising interest rates until something blew up. The Fed stopped last year, and the fuse was a few months long, but ... KABOOM.

This week, new Fed Chairman “Helicopter Ben” Bernanke tried to smother the resultant fire by dropping dollar bills on the flames. In the near term, **the Fed's decision to lower short-term interest rates is good** for the consumer and corporations alike, as it will alleviate pressure on the credit markets. Stocks have responded favorably. That said, the long-term effects remain to be seen, and we are somewhat more concerned than we were a few months ago that we might see a slowing of economic growth and corporate earnings. We are pleased to see the overall stock market is now back at our “fair value” target for the year, so we remain relatively neutral with regard to valuation (prices aren't cheap, but they aren't expensive either.) We are seeing interesting opportunities in some sectors, and anticipate a favorable outlook from the companies in which we invest.

So much for brevity!

Continuing our philosophy of being a good corporate citizen, we are very pleased to announce that FBB Capital Partners is sponsoring students from the **Don Bosco Cristo Rey High School's corporate work-study program** this year. Located in Takoma Park, Maryland, Don Bosco Cristo Rey offers a preparatory curriculum for students who dream of going to college but have limited financial resources. Students attend classes four days a week, and work at one of twenty participating firms on the fifth day. There are currently eighteen Cristo Rey high schools in cities across the United States, with Don Bosco Cristo Rey High School the only network school in the Washington DC area. We invite you to visit their website for more information: www.donboscocristorey.org

Sincerely yours,

Mitch Schlesinger
Managing Director