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Aureus Asset Management
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The Sub-Prime Credit Crisis

In the past three months, sub-prime mortgages have played an integral part in the global capital markets. This paper explores how this previously little known segment of the US mortgage market has affected investors. We will also discuss how this situation spread earlier this summer to other seemingly unrelated financial markets worldwide. Finally, we summarize our thoughts on the impact of this crisis, and the various potential regulatory, governmental and financial responses to it.

I. How Did It Happen?

The mortgage market in the United States is very large, amounting to about $10 trillion. Of that amount, about 14% is in sub-prime mortgages, the lowest rated on a credit scale. In turn, a very high percentage of sub-prime mortgages were issued in the last three to four years. Prior to 2003, sub-primes accounted for little more than 5% of the total mortgage market; however, the market for such loans expanded dramatically in recent years, to a point where over 15% of all mortgage loans granted in 2005-2006 were sub-prime.

Several factors were responsible for this market expansion. Appreciation of housing values drove the desire of Americans of all income levels to own a house as soon as possible, interest rates remained low, mortgage brokers saw a huge new product to sell, savers were attracted to higher than average rates of return despite the associated risks, and inventive lenders created synthetic instruments which packaged thousands of sub-prime loans into a single instrument, allowing them to be resold to a large base of investors around the world. These conditions remained in place for several years, permitting a positive and self-reinforcing market cycle to develop, which reflected investor confidence.

On the surface, the synthetic instruments allowed sub-prime risk to be spread over a diversified and broad base. Rating agencies graded each instrument's risk profile by quality, relying on past records of housing prices and foreclosure rates. In hindsight, these new financial instruments suffered from lack of transparency, as nobody (buyers, sellers, or rating agencies) fully understood the separate risks from each mortgage or what impact a severe downturn in real estate prices might have on their value and liquidity.

When investors realized earlier this year that the housing market was seriously overbuilt, they also feared that price declines and foreclosure rates would be considerably higher than in the past. In fact, as the market for new sub-prime loans contracted, serious questions were raised as to the value of the approximately $1 trillion of such loans issued in 2005 through early 2007.

The holders of these loans are principally hedge funds (which focus on credit markets or multiple trading strategies), commercial banks, insurance companies or investment banks. These owners are disseminated around the world and can be hard to trace. For example, commercial banks own these instruments principally through off balance sheet subsidiaries which are not consolidated into the banks' financial statements or disclosed in their annual reports. Some holders also leveraged sub-prime instruments by borrowing against them, up to several times the stated value, thereby substantially increasing their effective exposure. As a further complication, there was no truly effective secondary market in these new instruments; instead, prices were determined not in the market but by arbitrary mathematical models.

This summer, as falling housing prices prompted investors in hedge funds and other entities exposed to sub-prime debt to redeem, the weakness of these new instruments became apparent. With a very limited secondary market, it was difficult to establish a true market price. Therefore, the hedge funds and other owners of the debt instruments, when faced with redemption requests or margin calls, had to sell other, more easily marketable investments such as equities, and government or corporate bonds. Thus, the contagion of the sub-prime market mess has affected other seemingly non-related market segments. A completely different cycle ensued, reflecting investor caution.

II. What Happens Next?

The impact of the sub-prime crisis has the potential to persist for some time. Confusion over how to value sub-prime backed instruments, their limited secondary market, and the difficulty in identifying holders of the instruments are factors that contribute to the complexity of the situation. As a very important balance, monetary authorities and central banks will continue to provide liquidity and reduce interest rates as needed in order to limit market fallout.

Because of overbuilding, the housing market may be sluggish for a year or two. US consumer spending may also be affected by the housing downturn.

As the housing and credit markets find their respective equilibrium, we expect that investors, as well as regulators, will insist on more stringent future disclosure and transparency standards for all forms of credit instruments. Market volatility, which was very low in 2004-2006, has returned to higher and more normal levels and may well remain there. Aggressive users of leverage may find it prudent to reduce the debt exposure on their balance sheets. A change in the way agencies rate complicated debt instruments is also probable.

The US government may act to mitigate the potentially onerous impact on home-owners, of interest rate adjustments on the more than $600 billion of sub-prime debt due to reset in 2008. These possible changes will offer buyers and owners of financial instruments better information about risk/reward tradeoffs. However, implementing these changes will take massive and lengthy cooperation between central banks, governmental agencies, regulatory bodies, and the present owners of the sub-prime mortgages.

Summary

Too much appetite for risk produces the seeds of its own undoing. This adage has been reinforced over the past several months as excesses in the sub-prime mortgage market touched off a broader credit crisis. Yet there are important countervailing influences, which lead us to believe that this crisis is now much better understood and capable of being resolved in time.

At Aureus, we take confidence in the fact that many economies around the globe are still strong and many countries have very considerable reserves on their balance sheets. We believe that our posture of global diversification, backed by concentration in investments with comparative transparency and simplicity, should prove rewarding.