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Real Estate Brokerage/Retirement Planning

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The Impact of the Alternative Minimum Tax (AMT) on Leverage Benefits

My associate Matthias Schoener has pointed out to me that my analysis of mortgage tax benefits in June failed to allow for the possibility that clients may be subject to AMT and therefore might not be able to use mortgage interest deductions. Such a situation could substantially alter the cost benefit analysis and therefore each individual must take care to analyze their own particular situation to determine the actual cost of leverage relative to its benefits.

House Prices Are Going Down

The most authoritative indices of housing prices are the S&P/Case-Shiller (Shiller) housing indices. Most media-reported prices are medians of recent sales and therefore changes in the mix of houses sold affect the statistic as much as actual market price changes. The Shiller indices, however, use repeat sales to determine actual market price changes separately from changes in what is selling.

The Shiller index of 20 cities for August, which was released September 25, 2007 showed a year over year drop of 3.9%. A few markets were actually still showing increases (Atlanta, Charlotte, Dallas, Portland, and Seattle). Some of the metropolitan areas of interest showing drops were:

Las Vegas	-6.1%
Phoenix	-7.3%
Los Angeles	-4.8%
San Francisco	-4.1%

Given what has happened in the mortgage market (as described below), we can expect these declines to accelerate going forward and the markets with appreciation are likely to reverse. I would not be surprised to see the above 4 markets drop at twice this rate over the next year. Investors that make bets on the indices for Las Vegas, Los Angeles, and San Francisco[1] in the futures market are betting on declines. Based on the mid points between the bid and ask prices, the

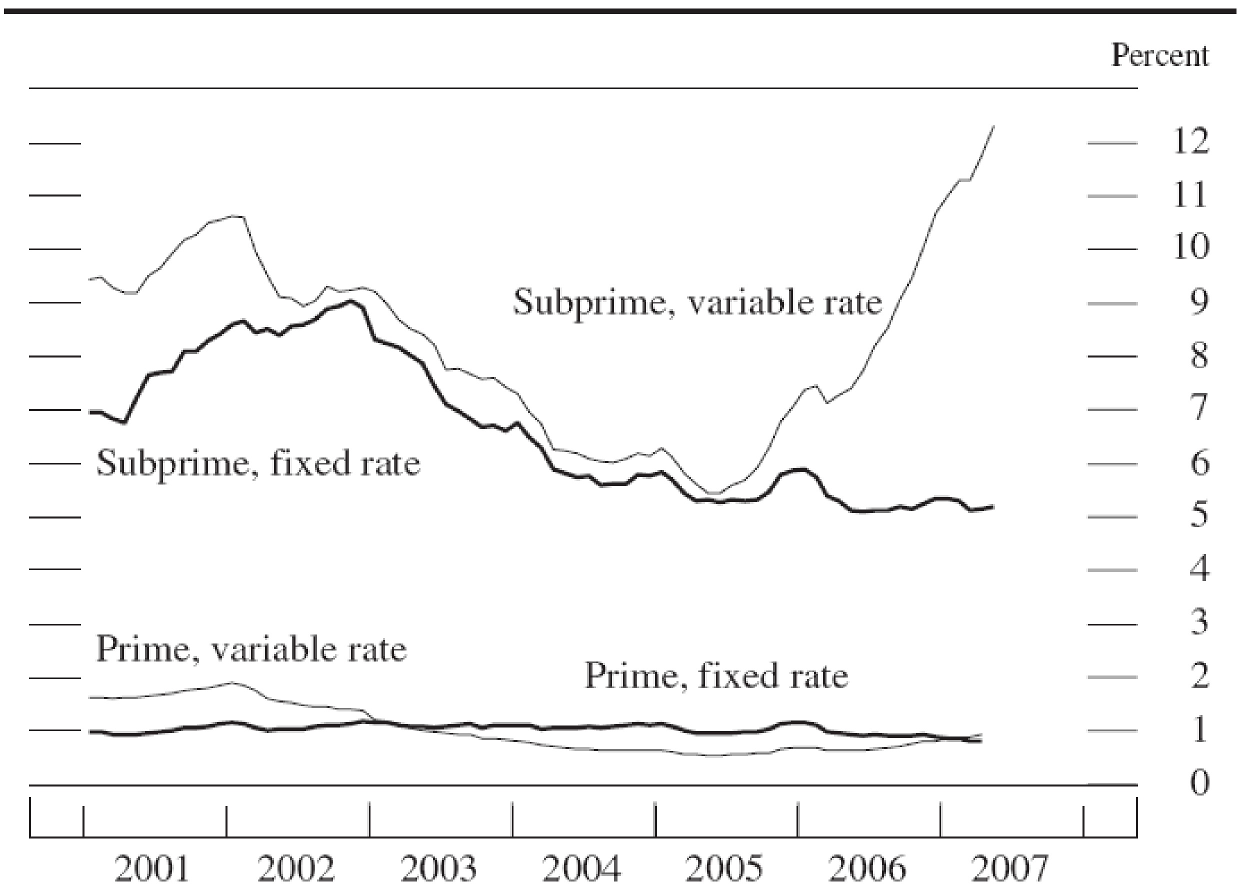
[1] There is no contract for Phoenix.

market is predicting further declines ranging from 5.4% for San Francisco to 7.6% for Las Vegas.

Mortgage Market Meltdown

Rapidly increasing defaults in the mortgage market finally reached the point where market participants realized that assumptions underlying the whole mortgage business are probably false. This started with subprime mortgages but defaults of some other mortgages are also rising and suddenly nobody knows what any mortgages are really worth. The impact on real estate and the whole economy will be significant. I will explain what is going on and why it matters.

Mortgage delinquency rates, 2001–07



NOTE: The data are monthly. Prime-mortgage data extend through April 2007, and subprime-mortgage data extend through May 2007. Delinquency rate is the percent of loans ninety days or more past due or in foreclosure. Prime mortgages include near-prime mortgages.

SOURCE: First American LoanPerformance.

Mortgage Market Terminology and Structure Explained

Subprime mortgages are home loans to borrowers with poor credit and/or little equity in the house. As house prices rapidly appreciated, originators of these loans loosened underwriting standards. It became easy for people to borrow money which they could never pay back unless the home increased in value enough to allow refinancing or sale at a profit. In 2006 these loans were 20% of total originations. This year delinquencies of more than 90 days jumped to 8% of these loans and foreclosures are running at 2.5%. Based on the results from the last recession and the much looser underwriting in this cycle, these figures are likely to double by next year. Apparently lenders and rating agencies did not properly estimate these losses and the surprise has sparked market turmoil as the value of these loans is reassessed.

Prime Mortgages are home loans to the most credit worthy borrowers with equity and fully documented income to pay back the loans. These loans are much less likely to pay late or be foreclosed. So far delinquencies are low but there are indications that some consumers with variable rate mortgages are starting to experience difficulties. The prime mortgage foreclosure rate is still only .25%.

Conforming mortgages are those that follow the underwriting guidelines of government agencies and therefore can be guaranteed by these agencies. No one worries about these mortgages since they are effectively government obligations. Therefore, the market for securities backed by these mortgages has not been affected. The limit for these mortgages is $417,000. Bigger mortgages, required in California and New York, are called Jumbo mortgages.

Historically, banks carried mortgage loans on their books and many mortgages are still on bank balance sheets. Government regulations are meant to limit the risk of the bank failing by specifying the amount of capital required to hold mortgages. In return the banks have access to insured deposits and can borrow large amounts of cash from the Federal Reserve when needed. Since the Federal Reserve directly controls bank liquidity, the banks are much less susceptible to withdrawal of funding than non-bank entities. While this system is good for addressing real economy liquidity, the costs of holding the required equity has led to unregulated entities holding much larger proportions of mortgage assets.

These days, mortgages are most often securitized by mortgage companies. The originator pools a large number of mortgages together in a trust and sells ownership interests in the trust in the market. These are called mortgage backed securities (MBS) when they are residential mortgages or commercial mortgage backed securities (CMBS). Once securitized, mortgages can more easily be bought and sold and thus they can be pledged as collateral for loans. These securitized mortgages are purchased by investment companies such as real estate investment trusts (REITs) and mutual funds. They may also be used to back other related securities like commercial paper.

Unlike banks, mortgage companies and REITs do not take deposits and do not have access to the Federal Reserve's borrowing facility. They generally must borrow money to fund their holdings of MBS and CMBS. One type of borrowing is called a Repurchase Agreement or Repo for short. The holder of the security sells it at a discount but simultaneously enters a contract to repurchase it. If they fail to repurchase the security per the Repo contract, the buyer has the right to sell the security at market price and keep the discount as profit – thus wiping out the seller's ownership equity in the security. Another way to borrow money on these securities is to issue short term promissory notes secured by the underlying MBS or CMBS. These notes are called asset backed commercial paper. Both of these types of borrowing are very short term – with maturities generally around 30 days. There may also be provisions in the Repo contracts that allow the buyer to call for additional collateral if the price of the Repo securities declines.

Another slightly more complicated variant is called a Collateralized Debt Obligation (CDO). This is a trust which may contain MBS, CMBS, or any other kind of debt obligation the creator may decide to include. These securities, however, are divided into different classes with different terms and seniority of payment. The classes that are paid last are referred to as subordinated and they lower the risks to the more senior classes in the same way that equity in a home lowers the risk of default on a mortgage. CDO securities, like MBS, have long maturities that match the underlying debt securities. Therefore a CDO issuer can issue long term low risk CDO securities to effectively leverage their holdings of MBS and other debt. This is a superior strategy (in terms of liquidity risk) compared to funding using Repo or commercial paper because the lenders cannot force liquidation of the assets in the event that asset prices decline.

Mortgage Market Liquidity Evaporated

The rapid increase in subprime mortgage defaults and delinquency shown in the prior graph was apparently not priced into the subprime mortgage rates nor properly forecast by rating agencies. Therefore the market value of MBS and CDOs backed by these loans has declined rapidly as people realized that the ratings assigned by the agencies (S&P, Moody's) are inadequate for assessing risk and value. This is not a problem for conforming loans guaranteed by the government agencies (FNMA, and FHLMC) since everyone agrees the government still has good credit.

For non-conforming loans and related MBS, there is no consensus on how to price these securities and therefore trading volume has dried up. While there has been very little increase in defaults on Prime Mortgages, the market is concerned there may be future problems lurking there as well. In addition, the sudden disappearance of the market for subprime related securities caused distress for many holders of these securities as their funding sources demanded repayment of loans against these securities. This led to forced liquidation of prime MBS to meet loan payments on subprime.

The sudden increase in supply of MBS for sale combined with the uncertain default environment caused potential buyers to step back from the market. Thus, trading in these securities also declined significantly and market values dropped and became uncertain. Because most holders of these securities are non-banks using a lot of leverage (a mortgage REIT's equity is generally less than 8% of its assets), these rapid declines in asset values threaten their solvency. As they go broke, more securities are dumped on the market which creates a vicious circle of financial distress. The result is that the non-bank portion of the mortgage finance system is being forced to de-leverage; this has severely decreased capital and liquidity in the mortgage market.

The massive wipe out of liquidity has vastly increased demand for bank lending. The Federal Reserve, along with the central banks all over the world, has had to inject huge sums of cash into the banking system. This may prevent a decline in bank credit but it may not help the mortgage market players much unless the banks can figure out the true value of the MBS and are willing to use their capital to take on the risk in this market. This remains to be seen.

Implications of the Blow Up

This episode has highlighted the risks of holding too little capital against MBS portfolios and funding with short term borrowing. Going forward, REITs and other non-bank entities holding MBS risk will need more equity and longer maturity borrowing. Both of these raise their cost of capital. The result will be that the mortgage originators will price mortgages at larger spreads versus Treasury securities.

The bigger picture is a huge reduction in the capital flowing into the real estate market. This huge reversal of the increasing flows of capital we saw in recent years will drive up interest costs on mortgages and reduce the availability of credit to lower quality borrowers. The result, fewer and smaller loans, cannot help but cause a drop in real estate prices. We can expect many house sales contracts signed prior to the market turmoil to be cancelled when the buyer cannot obtain a loan. Sellers will have to lower prices if they want to sell.

Stock and Bond Market Effects

The mortgage market blow up triggered a market wide reassessment of credit risks and a widening of all credit spreads. This has increased borrowing costs for all companies and dramatically reduced the viability of leveraged buy outs. The increased credit costs caused drops in bond prices and threatened to put the economy in recession. This is what caused the declines in the stock market. The Federal Reserve's cut in interest rates, has offset the increased spreads and insulated businesses from the impact of the re-pricing of credit risk. The increased liquidity coming from the injection of additional reserves is likely to encourage market participants to do the analysis required to start bidding for beaten down MBS and profit from providing liquidity to the market.

There have been many side effects to the blow up in the mortgage market and related flight to quality and liquid securities. Just as in 1998, many securities have been sold off by funds needing to raise cash - without regard for the intrinsic value of the securities sold. This is exactly what happened in 1998 that enabled me to achieve a 75% return on my investments in 1999. Here again in 2007 we see many opportunities to buy stocks at discounted prices even when their underlying business is not impacted by the market disruption.

Commercial mortgage REITs, for example have had very large declines – some as much as 50%. Sellers are dumping these stocks without analysis because they fear these companies could have liquidity problems similar to the residential mortgage players. I have analyzed these REITs to those who have structured their balance sheet to avoid such a liquidity crunch. There are several that should have no difficulty getting through the crisis with their business and earning intact. We are buying these at huge discounts and collecting fat dividends while we wait for the crisis to pass and valuations to return to normal. I expect the special situations portfolio to earn big returns as this crisis eases. Meanwhile the Federal Reserve's aggressive rate cutting should cushion the economy wide effects and provide a favorable environment for our long-term value portfolio.

Conclusion

Housing prices are headed down in the markets that ran up most in the last few years and this will likely continue well past 2008. Anyone who can reduce exposure to housing should do so. There will be plenty of opportunity to buy foreclosed houses at big discounts once foreclosure sales reach 10% of market sales. Those with the time to pursue these opportunities should build their liquid positions now. The timing for investing in our stock portfolios looks very good and this strategy should vastly outperform real estate over the near term. I urge any of you with money to invest, to open your account at Berkeley Investment Advisors now. The time is right.

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