



## “They just got a fat white guy to eat a worm”

Brian Rulapaugh, my son

“Bizarre Foods” is a show on *Travel Channel*. It is hosted by self-described food critic, chef and world traveler Andrew Zimmern. Mr. Zimmern visits exotic places in search of unusual stuff the natives eat. It is obvious that he enjoys the shock value of chewing on what we try to exterminate here in Arizona. I’m not one to criticize what other folks eat (unless it’s *Twinkies*) but I don’t want my “dinner” crawling out of the bowl. It’s not easy to watch this show and you certainly don’t want to watch during supper.

The stock market the last few years has a lot in common with this TV show. Wall Street employs experts to find new and unusual ways to invest. They travel the globe looking for the latest hot investment opportunity. What they find may not be pleasant or palatable but investors feel left out if they don’t get involved in the “trendy.” Unfortunately, trendy can be expensive and ultimately distasteful. Investors in the “subprime” mortgage market are discovering that now. They were gullible, believing that the local experts, who obviously had far more knowledge, would treat them well. The natives fed them worms.

Most people understand the mortgage generation process. You borrow to buy a house and the bank lends the money from cash supplied by depositors. Years ago, when a bank made a mortgage loan to a customer known to the bank, it was making an investment for its own portfolio. The bank would hold that loan until it was paid, perhaps thirty years after origination. Then some geniuses decided to package bank loans and sell the package to another bank or investor with the original bank retaining the “servicing.” Since the originating bank charged a fee for taking payments and keeping the books, banks became more interested in the fees than the mortgage itself. The sale of the mortgage package brought in cash to the bank with which to make more loans. Government helped fuel this activity with the creation of Fannie Mae and Freddie Mac. Because Fannie and Freddie bought only good loans, this left the banks with the poorest loans in their own portfolios. Enter Wall Street. The big brokers bought the lower quality loans from the banks, packaged them, and then sold the packages to pension funds, mutual funds and the public.

Because of the complexity, small size, risk and busy work involved in a mortgage, a portfolio of mortgages yields more than a generic Treasury security which is absolutely secure and easy to administer. An investor in a generic portfolio of mortgages would realize diversification by location and quality. Quality would generally be high because the investor knows it isn’t easy to qualify for a mortgage. Investors also know from their training that the lower the quality of the security, the higher the yield. It would be logical to assume that a package of low quality mortgages would pay more than the standard package of normal mortgages. In the quest for yield, the low quality “subprime” credit market’s popularity exploded. Eager, but generally unqualified, families could now get credit in amounts never available before, enticed by the prospect of low payments. You only need to watch CNBC for a few minutes before you see an ad from “ditec.com,” a unit of GMAC, advising viewers to refinance their interest-only loans before its too late or to use their home as an ATM to get some cash out for current bill. Naturally, the fine print warnings/disclosures are so small as to be unreadable.

For a while, subprime lending by banks and others was a fantastic business. The margin for selling a package of mortgage loans could be as high as 2% after expenses. That would mean fees of \$100 million for packaging \$5 billion of loans, loans that had been made to people who may not be able to pay them back. (“No credit? No problem.”) Investors, chasing high yields in a low yield market, bought billions of dollars of packaged subprime loans. Stocks of companies like NovaStar, IndyMac Bancorp, New Century and Accredited Home Lenders soared. They were “pure play” stocks whose only business was the subprime mortgage business. Accredited Home Lenders described its business this way:

The Company originates, finances, securitizes, services and sells non-prime mortgage loans secured by residential real estate. Accredited focuses on borrowers who may not meet conforming underwriting guidelines because of higher loan-to-value ratios, the nature or absence of income documentation, limited credit histories, high levels of consumer debt or past credit difficulties. It originates loans primarily based upon the borrower’s willingness and ability to repay the loan and the adequacy of the collateral.

After reading this it is hard to feel sorry for investors who bought the questionable mortgages (also called “liar loans”) or for those who owned the stocks in companies that made these loans. Accredited was \$60.00 a share nine months ago and it bounced off \$4.00 in mid-March this year. New Century was listed on the New York Stock Exchange until March 13 when

trading was suspended after New Century's funding sources decided not to lend the company more money. What is left of New Century now trades on the "Pink Sheets" which is market speak for financial Siberia.

Now Congress wants to know what the regulators were doing about predatory lending, lending to folks who can't repay. The recent stock market swoon is being attributed to the rise in delinquencies among the subprime borrowers and the impact foreclosures are likely to have on the rest of the economy. It will have an impact, in my opinion, but not as much as the TV commentators want you to believe. How can it not? Some buyers will be shut out of the market and some owners will lose their homes but not in large numbers. And lenders that were silly enough to make loans without proof that the borrower had a job deserve to take a hit. Buyers of shaky securities need to understand the transfer of risk and not be allowed to demand their money back at the first sign of default trouble. Evidently a higher than normal yield wasn't enough of a warning for them.

The "subprime" label isn't limited to mortgages. There are subprime personal loans, too. Individuals with poor credit histories have always found it difficult to borrow money from legitimate sources. Years ago, when a bank was not receptive to your plea, you had to go to Household Finance or Beneficial Finance which charged modestly higher rates than the banks. If you were really desperate and had exhausted all other sources of credit, there was always Tony Soprano or one of his goons. I remember when I was working at Ford's Dearborn Engine Plant as a foreman over 40 years ago, one of my employees supplemented his hourly pay by working a "five-for-four" scheme during lunch and breaks. It was quite simple. You borrow \$80.00 from him on Tuesday and agree to pay him back \$100.00 on payday Friday. Yes, the interest rate is outrageous, but then again, to get involved you have to be pretty desperate.

Obviously, an individual involved in a "five-for-four" is below even what some would call a subprime credit risk. The lender had no risk because if the borrower failed to perform on payday, the borrower was subject to great bodily harm. I never saw any mayhem but heard reports about workers who couldn't make it in on Monday because they failed to pay on Friday. (The obvious question is why I didn't report the individual who is making the loans. His activities were known but would have been difficult to prove. I never saw the money change hands in either direction so there was nothing to report.)

Needless to say, "five-for-four" was extremely profitable so entrepreneurs, ever willing to grab an opportunity, got into the game. Here in Phoenix, it is hard to drive by a street corner or strip mall that doesn't have at least one version of a "payday loan" store in a building formerly occupied by a defunct fast food franchise. To borrow, you simply write a bad check for \$120.00, date it next Friday, and the store gives you \$100.00 cash. Next Friday, the check is negotiated and everyone is happy. Happy unless there's less than \$120.00 in the account. If the check bounces, fees are charged by both the bank and the lender and the loan is rolled over for another week with yet another fee. The hole gets deeper and deeper. Fees and interest can be as much as 1,100% a year according to a recent Canadian study.

There are over 22,000 payday lending outlets in the USA with more opening every day. You can even take a three-day seminar on opening your own payday loan store. The largest in the business is Advance America (AEA on the NYSE) for those who want to invest in the payday loan business. (I don't and won't for clients.) AEA is a billion dollar company growing in excess of 10% per year with a return on assets of 18% yet selling for only fifteen times earnings. This is a really cheap growth stock for those with strong stomachs and few scruples. It may even be recession resistant because the worse the economy gets, the more "clients" AEA is likely to attract.

Gullibility isn't necessarily confined to the desperate. I recently became reacquainted with enhanced-index funds, a product created several years ago when indexing was so popular. The concept is very simple. If indexing is good and the index returns are good, then why not impose some active management on the index to make the returns a little better than the index. DWS Scudder Enhanced S&P 500 starts with the S&P 500 and then weeds out 20% of the companies the manager thinks will underperform. Rydex Nova tries to beat the index bogey by guessing which way the market will move and then purchasing derivatives to increase the leverage. PIMCO StocksPLUS try to beat the stock index by using S&P 500 index futures in a fund that is invested mainly in bonds. But once you tinker with an index fund, it isn't an index fund any more. Rydex Nova, for example, beat the market three out of the last five years. A \$100.00 investment five years ago would be worth \$124.00 today. A straight, unadulterated index fund during the same period would be worth \$135.00 now. Enhanced indeed. True professionals know immediately that the only thing being enhanced with these products is the lifestyle of the manager and the consultants who recommend them.

Still, investors will always be on the lookout for a trendy gimmick that sounds great and a theory that reads like poetry. After all, they are strangers in a strange land and the natives wouldn't lead them astray, would they? "Here. Try this worm."

---

**Stanley E. Rulapaugh, CFA. Investment Counsel. A Registered Investment Adviser**  
**7505 E. 6th Avenue, Suite 204, Scottsdale AZ 85251-3520. (480) 941-0820. [www.serulapaugh-cfa.com](http://www.serulapaugh-cfa.com)**

This memorandum is based on information available to the public and no representation is made that it is accurate or complete. Information contained was developed for use by the firm for purposes of establishing investment policy. Any other use is at the reader's own risk. Quotation with attribution allowed.