CLiENTFIRST Strategy, Inc.

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ClientFirst Strategy, Inc.
For immediate release.

Here's why the stock market got pounded…Sub-prime was merely the tip of the iceberg made of faulty assumptions…The Titanic of our economy…

Keeping it short and to the point…The explanation you need…

If you're starting to think that there is more than meets the eye regarding the cause and effect that the current sub-prime mortgage/housing crisis has had on the economy and market, you're right. The subprime mortgage/housing issues, as it turns out, was merely the tip of the iceberg. The giant mass of ice below the water line of our economic ship that you didn't see is the Collateralized Default Swap securities.

1. **Alphabet soup**: **CDS** is the acronym for Collateralized Default Swap. A CDS is akin to an insurance policy contract against losing money on a bond due to default of interest payments or a bankruptcy on the part of the issuer. In the event that this happens, the buyer of the CDS is entitled to be made whole.
   MBS is the acronym for Mortgage Backed Security. When a financial services firm packages a large number of mortgages into a single unit, it is a bond called a MBS. If a bunch of home owners defaulted on their mortgages, like subprime borrowers, the MBS's would default. Major players in creating MBS's and CDS's were Bear Stearns, Lehman Brothers, and Merrill Lynch. AIG was a big creator of CDS's.

   The creator of a CDS would collect a small amount of money (like insurance premium) from the buyer. Unfortunately, the creators of CDS's didn't keep nearly enough money in reserve because they assumed only a small number of subprime mortgage borrowers would default.

For example, a life insurance company collects premiums from lots of customers (policy holders). A lot of this premium (money) collected from policy holders is put into safe

investments and is used to pay out claims to the policy holder's beneficiaries. It is assumed by the insurance company using actuarial statistics that only a certain amount of insured people will pass on at any given time. If the insurance company is wrong on its assumptions and it doesn't have enough in reserves, it has to liquidate itself. Of course in the real world, insurance companies are regulated and they have contingency plans in place to protect consumers. But at the end of the day, it is the future accuracy of these assumptions which will determine how well the insurance company performs. If the insurance company assumptions are very wrong, it will be put out of its misery and the policies will be absorbed by another insurance company.

2. **The key here is three-fold.** First, the assumed rate of MBS defaults should've been much higher. This caught the CDS creators off guard. The defaults required these firms to post more money as collateral. Without access to more capital, these firms would become insolvent. Second, reserves should have been much higher. CDS creators, like insurance companies, would rather have less money in reserve and more money to create even more CDS's – a very profitable business on a large volume basis. Third, the CDS market is unregulated, unlike the insurance industry. AIG, traditionally in the business of regulated insurance products, found it much more profitable to be in the unregulated CDS market. Reserves didn't have to be locked up in safe investments; they could be used to create more CDS's. See how this works? Once the mortgage meltdown began, these 3 issues contributed to a massive default potential in the CDS market, which is estimated to be valued at over $55 Trillion! It is such a big number because CDS's are created to protect against defaults in lots of other kinds of securities beside MBS's. It's just that the soured mortgage market was the spark that lit the fuse. Also, if a CDS creator doesn't need much in reserve, it can take the premiums paid and leverage itself by issuing more CDS's. Less reserve EQUALS more leverage!

Now, with so many companies on the hook for so much bond default insurance but lacking sufficient reserves to pay out claims, they either have to get a Government bail out, a rescue merger, or they have to become insolvent. After all, the creators of CDS's are contractually obligated to make the holders whole. With over $550 Billion worth of issued CDS's on the part of AIG, you can now see why many people think it was too big to fail.

Bottom line, a handful of large financial services companies earned a ton of money short term by putting our entire financial system at risk and this is why the Government had to spend $1.8 Trillion…so far. I hope this over simplified explanation helps you to understand what was so bad. My sense is that the financial system is on the mend and for what it is worth; I think it is time to go deep…on deep cyclical stocks that pay dividends. Last, I want to point out my continued belief that the current economic environment is very similar to that of 1989 to 1991. What followed was a great bull market.

Thanks for reading this. Please forward this to anyone you know who may find it interesting (or amusing). Please reply me if you'd like to comment.

Interested in becoming a client? Call me. Let's talk about it.

(Disclosure: This is solely MY opinion. Of course, you are welcome to share your opinions with me too. If you act on any of this without speaking to me first and you lose money, don't blame me. I may be wrong. I reserve the right to change my mind about any of this whenever I want and without warning. We're NOT totally out of the woods yet! Have a great freaking day! ☺)

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