

# Perspectives

## FNMA: A Study in Risk and Reward

December 8, 2004

Curiously, since news of FNMA's accounting and management problems became known, the spread of FNMA bonds to U.S. Treasuries (the extra yield FNMA pays over the yield of a comparable maturity treasury bond), has barely moved at all. FNMA spreads remain at the richest levels in many years. While the bond market continues to give FNMA a vote of approval, we disagree with the market's conclusion. As a result, we currently do not anticipate buying bonds issued by FNMA for our clients because the current yields offered by these securities do not, in our view, adequately compensate investors for the risks associated with the organization.

When Franklin Roosevelt created the Federal National Mortgage Association (FNMA) during the Great Depression, his objective was to stabilize a creaky, illiquid financial system that had been wracked by scandal and system threatening panics. In the better world envisioned by the ever cheery Roosevelt, FNMA would help revive the promise of the American dream by providing liquidity to the nation's mortgage bankers so the troubled lenders of the time could resume the business of helping Americans buy homes. For many years the system worked in just this manner.

At its most basic operating level, FNMA issues bonds in its own name and uses the proceeds to buy mortgages from lenders, providing the very liquidity to the system that FDR envisioned. FNMA packages many of these mortgages into pools of mortgage-backed securities (MBS) and sells them to investors. In contrast to MBS issued by FNMA, which are collateralized by pools of mortgages, it is the direct obligations of FNMA that concern us. FNMA, a private corporation whose stock trades on the New York Stock Exchange, has a special allure among bond investors. This is because it has a line of credit at the U.S. Treasury, operates under a Federal charter, is exempt from paying state and local taxes, and has a unique mission. Bond investors view FNMA's line of credit at the U.S. Treasury as proof that the Federal government will always bail it out if necessary. As a result of this belief, FNMA is able to raise capital at interest rates substantially lower than a traditional private corporation, certainly lower than a comparable company in the midst of an accounting scandal. In fact, however, FNMA's obligations are not backed by the full faith and credit of the U.S. Government.

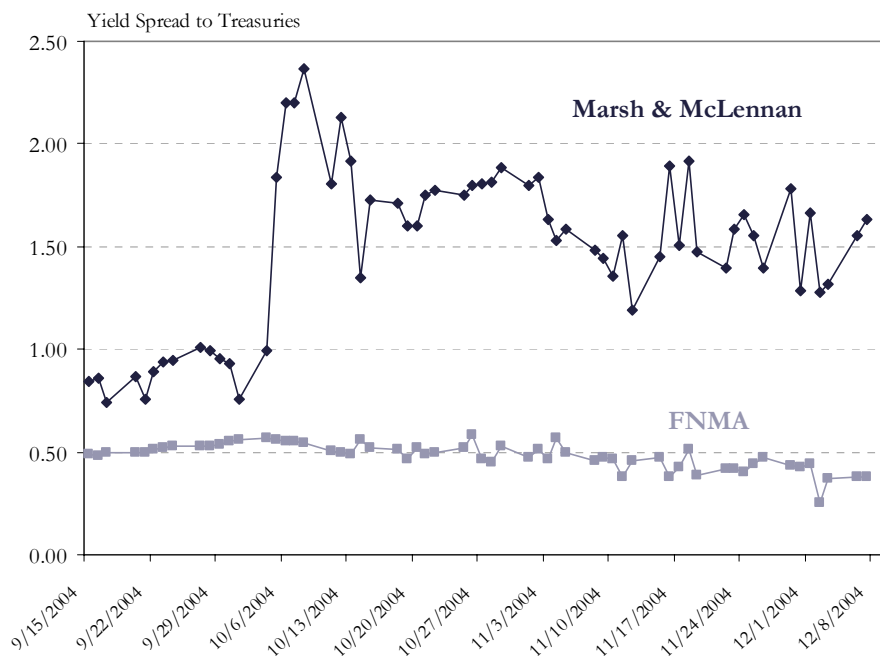
Why do bond investors treat FNMA as a U.S. government agency even though its own website points out that it is not part of the government? Why do bond investors continue to ignore the warning signs about FNMA?

Just as "irrational exuberance" can lead to an extended period of rising equity valuations, well in excess of valuations justified by the fundamentals, so may "irrational exuberance" lead to a rise in a bond's valuation beyond what is justified by the facts. We believe FNMA is a particularly good example of this principal at work in the bond market today. A review of FNMA's recent problems suggests that investors should be more cautious before purchasing FNMA bonds. Armando Falcon, Jr. is head of the U.S. Government's Office of Federal Enterprise Oversight and in this role serves as FNMA's chief regulator. In a September letter to FNMA's board of directors, not only did he accuse the company of improperly manipulating its earnings, he also revealed that FNMA's accounting problems were the product of a deeply troubled organization. According to Falcon, inadequate internal controls, poor risk management policies, and a culture that promoted a willful violation of proper accounting procedures to better manage its earnings, are the hallmarks of FNMA. In the meantime, the SEC has opened a formal investigation into FNMA's accounting policies and Ohio's Attorney General, Jim Petro, has initiated a lawsuit against FNMA accusing the agency of securities fraud. He is suing FNMA on behalf of the Ohio Public Employees Retirement System for manipulating its earnings to artificially inflate its stock price. Some observers accuse Falcon of political grandstanding and rationalize their continued investment in FNMA bonds on this argument. Others may diminish Petro as a politician. The SEC is harder to dismiss, but the market has not taken the SEC's investigation seriously. FNMA has been in the press so frequently for various problems in recent years that

the market has simply become deaf to the subject. Despite these unresolved matters, FNMA bond spreads have remained at very rich levels.

Other companies under regulatory attack in recent weeks have been severely punished by the bond market. Since New York Attorney General Eliot Spitzer accused Marsh & McLennan of steering “unsuspecting clients to insurers with whom it had lucrative payoff agreements”, and soliciting “rigged bids” for insurance contracts, investors have been selling the company’s bonds. This has led to a significant increase in the additional spread the company must pay over the interest rates offered by U.S. Treasury bonds. At the same time, Moody’s and Standard and Poor’s have reduced Marsh’s credit rating from A to BBB. In contrast, it should be noted that FNMA’s ratings have not been downgraded.

### Spread Performance: FNMA vs. Marsh & McLennan

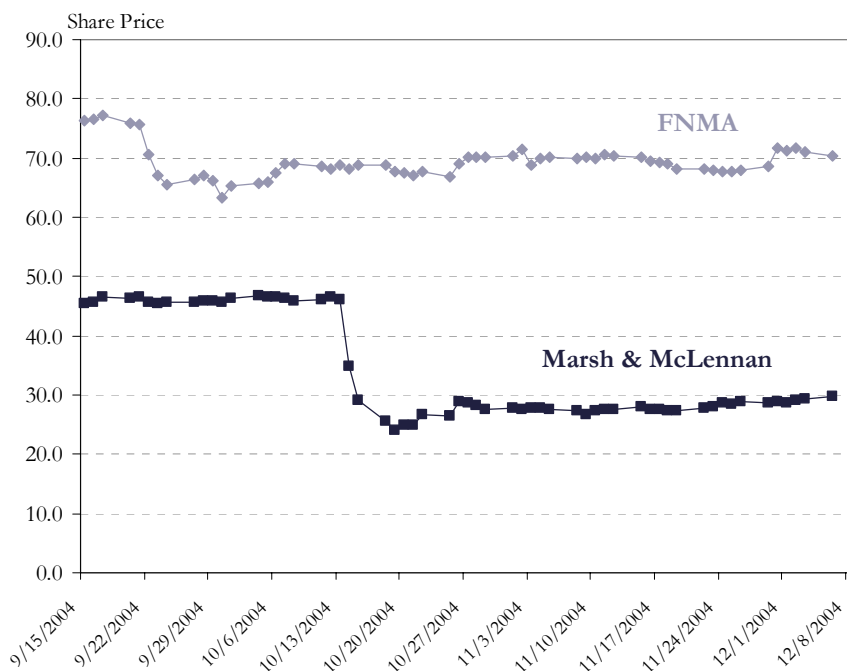


We believe FNMA bond investors are ignoring the risks associated with FNMA. The stability in FNMA’s spreads, when contrasted with the volatility in Marsh spreads, highlights this phenomenon. We are not suggesting that FNMA’s troubles will necessarily cause their bond prices to drop sharply or that the company’s credit ratings will definitely be downgraded. Nevertheless, given current tight spread levels to Treasury bonds it will only take a modest widening of spreads from 40 basis points at present to 46 basis points for ten year maturity FNMA bonds to underperform comparable maturity Treasury bonds over a 12-month holding period.

Is it possible for FNMA spreads to widen by 6 basis points or more over the next year? Certainly the performance of Marsh’s bonds is instructive, but FNMA’s past also offers a lesson. In 2000, a time when FNMA was under severe Congressional scrutiny, its 10-year maturity bonds traded at about 130 basis points over Treasury bonds – about 90 basis points wider than today’s levels. Admittedly, that was a higher interest rate environment, and all agency spreads widened at this time, but it underscores the point that 6 basis points is a slim cushion given the concerns about FNMA. We believe we can find more attractive, safer opportunities elsewhere – including other agency bonds and the growing taxable municipal bond market – and we would rather be cautious than complacent.

The recent stock performance of FNMA and Marsh & McLennan provides another vantage point to examine this issue. While bond investors have ignored FNMA's problems, but punished Marsh, equity investors have penalized both companies. FNMA has dropped from a high of \$78 a share to \$70, while MMC has fallen from a high of \$48 a share to \$29. The S&P 500 has risen from about 1,100 to about 1,180 over the same period. Admittedly, the problems confronted by FNMA and Marsh are different. Yet, equity investors, sensitized to risk by the recent bear market, appear less eager than their bond market brethren to overlook FNMA's foibles. Clearly, equity investors are taking the risks related to FNMA more seriously at the moment than bond market investors.

### Stock Performance: FNMA vs. Marsh & McLennan



If FNMA is cleared by its regulators (or reforms itself sufficiently to regain the confidence of its regulators) we will reconsider our stance. But until the investigations are completed – or spread levels widen enough to compensate investors for the risks – we will stay away from FNMA.

*There is no guarantee that the forecasts and opinions expressed in this article will be realized. The statements in this article are opinions only and are not guarantees or projections of future performance.*