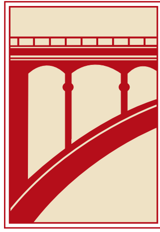

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FIRST QUARTER 2007

SURFING THE SUBPRIME TSUNAMI

by Terry Price

Lately, news reports have been filled with fearful stories surrounding so-called subprime mortgages. Many of our clients have felt some lack of understanding about these loans compounded by the often-expressed anxiety of the media. In order to better subjugate the current climate of fear, we thought we would explore the subprime situation from a more objective point of view.

WHAT ARE SUBPRIME LOANS ANYWAY?

Simply put, they are home loans made to borrowers with weak credit, erratic or no income, little or no documentation, or a poor credit history. They often include less collateral such as a low or zero down payment. The starting interest rate on these loans frequently begins below normal market rates. But very often these low starting "teaser" rates are adjustable and can be expected to rise after one or two years – possibly squeezing the borrower who was already on the fringe to begin with. In a nutshell, these are high-risk real estate loans made to people, who for various reasons, would not normally qualify for a traditional mortgage.

The advantages of such loans benefit both the lender and the borrower. First, lenders or loan originators have an additional product to

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SHOULD YOU CONSIDER A ROTH IRA CONVERSION IN 2010?

by David Andrew

Since Roth IRAs became effective in 1998, they have offered a compelling option for eligible retirement investors. But many remain uncertain whether it pays to convert assets already invested in a traditional IRA into a Roth IRA.

As a result of the new tax act passed last year, the Tax Increase Prevention and Reconciliation Act, more investors will have the option of making a Roth IRA conversion. Prior to the act, only IRA investors with modified adjusted gross incomes of $100,000 or less for a tax year could convert all or part of the money in their traditional IRA (Contributory or Rollover IRA) into a Roth IRA in that year.

There are several main distinctions between a traditional IRA and a Roth IRA. Traditional IRAs may offer a tax deduction for deposits and tax-deferred gains. But you pay ordinary income taxes when you retire and withdraw the money. With Roth IRAs, you deposit after-tax income, but pay no taxes on your investment gains if you follow the withdrawal rules. You can generally put only so much money in either IRA each year, and you are usually shut out entirely if you earn $160,000 or more.

Starting in 2010, the $100,000 adjusted gross income limit will be removed so anyone will be able to make such a conversion. Even investors with relatively high annual incomes who are approaching retirement or recently retired, as well as those still years from retirement, may find it worthwhile to consider a Roth conversion.

The advantage is that future earnings in a Roth IRA can be withdrawn tax free in retirement (after age 59-1/2) if the account has been established for at least five years. However, at the time of conversion the investor has to pay income taxes on the taxable amount of the traditional IRA (earnings plus deductible contributions) converted to a Roth IRA. (The 10% premature withdrawal penalty does not apply to conversions regardless of age.)

Therefore, investors must examine whether it is better to pay taxes at the conversion in order to be able to withdraw earnings from a Roth IRA income-tax free later during retirement. Or should money be left in the current traditional IRA, where it will

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sell. They can make additional profits that would not normally be available if they were restricted only to high-quality borrowers. Also, the costs of these loans to the borrower are usually very high which translates into high levels of profitability for lenders. Second, from the borrower's point of view, a subprime loan provides an opportunity to purchase a home which in the past would not have been an option until a better credit rating was established.

While representing only a minor percentage of overall existing mortgages, the subprime loan business evolved from almost nothing 10 years ago to become a more meaningful part of newly-issued loans during the last two or three years. One in five of all new loans generated over the past several years have been subprime. In total volume, the trade publication *Inside Mortgage Finance* estimates over $600 billion in subprime loans were originated just last year, up from only $100 billion in 2000. This business has clearly opened up the housing market to thousands who would normally not qualify, and in doing so stimulated overall demand for housing.

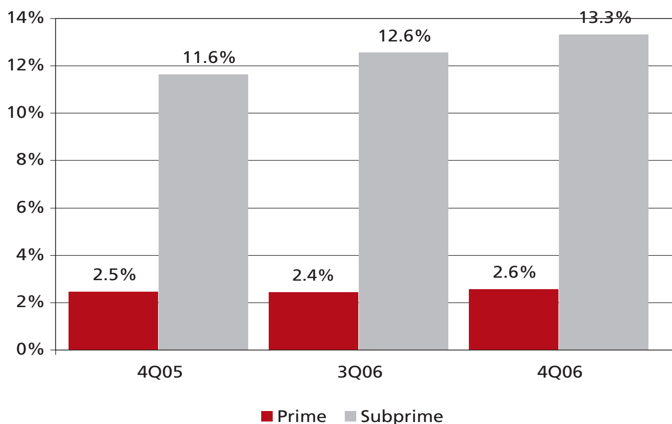
WHAT ARE THE RISKS?

To understand potential risks, we must first examine how these loans work. As mentioned above, a borrower takes out a loan which often includes a very low "teaser" or "incentive" interest rate intended to rise at some future date. The lender, who originates or arranges the mortgage, sells large quantities of them to commercial banks or Wall Street firms. The banks and Wall Street firms then repackage the loans into mortgage-backed securities – that is, bond-like investment securities that can be easily bought and sold by various investors such as hedge funds, insurance companies, other banks and institutional investors.

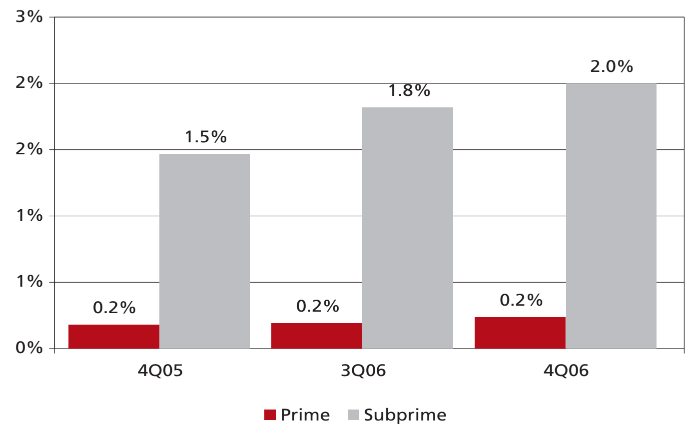
By the time the process is completed, the risk of default on the loan has been shifted from the originating company to the final investors. These investors are usually seeking higher returns than those available by more traditional fixed-income investments. And, of course, they are willing to take on a great deal more risk by doing so.

WHY ARE SUBPRIMES SUDDENLY IN THE NEWS?

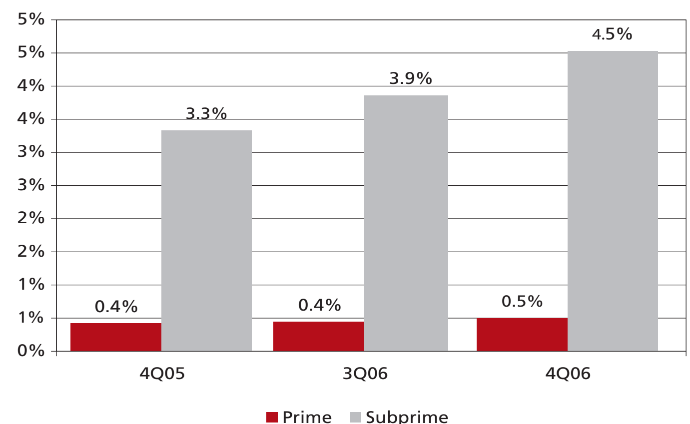
So long as the borrower makes a monthly payment, everybody is happy. But recent history seems to be painting a somewhat different story. From the just-released National Delinquency Survey of the Mortgage Bankers Association (MBA), trends in the subprime mortgage market have started to deteriorate. The MBA survey is quite extensive, covering 33 million existing high-quality or prime loans and 6 million subprime loans on residential properties. As shown in our first chart, the Delinquency Rate of monthly mortgage payments has been increasing over the past year – especially in subprimes.



Also, the Foreclosure Start Rate has increased to a new record high, driven by subprimes as shown in our next chart. The Foreclosure Start Rate measures properties just beginning the foreclosure process which normally takes several months to complete.



And finally, the total Foreclosure Inventory is also on the rise. These are all properties found to be somewhere along the way in the lengthy foreclosure process.



From all three charts, it's clear the deterioration in the mortgage market is being driven mostly by the subprime sector.

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Whereas some small degradation can be seen in traditional quality mortgages, it is minor and well within historical norms.

WHY ARE SOME INVESTORS CONCERNED?

As mentioned earlier, subprime lending is a fairly new and growing part of the overall mortgage lending business. And, until recently, it had evolved during a very positive period of both rising home prices and falling interest rates. However, during the past year or two, interest rates have risen somewhat while the price of housing has at the same time softened or declined. In general, Wall Street hates uncertainty and the fear it brings. The subprime market is untested in the real estate environment we find today. Thus investor uncertainty and fear levels are quite high.

WHAT POTENTIAL RISKS ARE ASSOCIATED WITH THE CURRENT SITUATION?

Some lending companies have concentrated almost exclusively in the subprime business. They tend to be newer companies with limited financial resources and often undisciplined or very aggressive lending practices. Their main source of daily cash flow often comes from the constant sale of mortgages to banks and Wall Street firms. If banks and Wall Street firms stop buying those mortgages, these one-product lenders suddenly find themselves in trouble. We've already seen this happen to companies such as New Century. Bankruptcy seems likely in these situations.

Other risks won't become clear until a bit further down the road. If defaults and foreclosures continue to rise, investors holding securities backed by the mortgages themselves stand to lose something. But at this point, it's not known how large this risk is. Remember, these are new and untested securities. The players here are hedge funds, insurance companies, some banks, and other investors who were willing to accept an above-average risk for a potentially above-average return.

Another area of risk involves something called a credit default swap. These swaps are designed to protect investors in mortgage-backed securities, but not in the typical way. That is, this is not mortgage insurance provided by commercial insurers who accept premiums and regularly set aside plentiful reserves to eventually cover future claims. Credit default swaps can be sold by anyone as "promises" to provide insurance should mortgage-backed securities go into default. So long as all is well, they are quite profitable to the seller who puts up little if any cash in return for a steady stream of cash flow payments as compensation for an eventual rainy day guarantee. But the quality and deep pockets of those guaranteeing swaps is unclear. And these arrangements have never been tested in a big way, nor are they publicly traded.

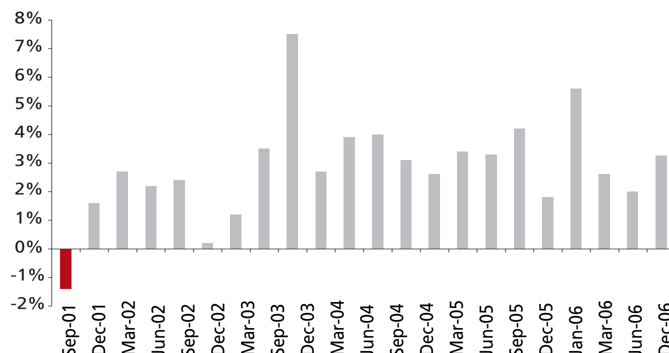
Finally, there is some fear that home prices themselves may continue to decline. Here's the argument. If subprime loan availability starts to dry up, demand from subprime home buyers would also decline. And if subprime foreclosure sales rise at the same time, the supply of houses on the market would also increase. That's pretty basic economics. If demand falls while supply increases, prices should decline.

In recent years, home equity has become a source of cash for many people, almost like a bank account. If home prices continue to fall, the ability of even high-quality borrowers to take additional money out of their homes might also dry up. If overall mortgage liquidity dries up, consumer spending as the main driver of our economy and current economic expansion could decline. That could potentially trigger the biggest Wall Street fear of all – an eventual "credit crunch" type of recession.

SO WHAT'S THE OUTLOOK FROM ALL THIS?

It should be remembered, the risks outlined above are all hypothetical. The subprime world is a very new and untested one. And as a percentage of all outstanding mortgage debt, that world remains very small. Until three or four years ago, subprime originations were a miniscule part of the mortgage market. The real explosion has really only been since about 2003 or 2004.

We're also mindful that a somewhat weak housing market has already been in place for the past year or two. It's likely the already-slowing housing market has contributed to the recently-slowing economy. But a slowing economy is not one that is necessarily in trouble. In fact, the FED has been hoping for just such a slowing economic scenario to control inflation.



Because the subprime business is a new one, no one is quite sure exactly how the present situation will work out. However, most economists have not significantly revised GDP forecasts downward. And neither has the FED. Therefore, we remain with our cautiously optimistic outlook. Specifically, we feel high-quality fixed income investments should preserve capital and provide portfolio stability and income in the future. We will therefore continue avoiding high-risk subprime securities.

As for stocks, we recognize the financial complexity and anxiety currently found in the marketplace suggests some caution may be warranted. We also recognize that earnings in general are moderating somewhat and stocks may therefore move modestly higher, though erratically, over the next 18 months. So stock selection continues to be paramount for us, especially in the very choppy markets we expect ahead. But fair valuations are still to be found for quality companies in which we expect above-average growth. We are positive overall, but cautious as we move forward. §

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continue to grow tax-deferred, but all earnings and deductible contributions will be taxed upon withdrawal. (Note: In 2010 only, investors who make Roth conversions will have the option of paying the taxes due on the conversion ratably over a two-year period.) Generally speaking, investors should plan to pay any taxes due using assets held outside of their IRA so that the full IRA amount can grow tax-free in the Roth IRA.

KEY CONSIDERATIONS

Some of the factors to consider in making this decision include:

- How much time you have until you begin taking the money out of your IRA and how long you expect to make withdrawals from your IRA after you retire.
- Your current tax bracket and projected tax bracket in retirement.
- Whether or not you will want to avoid taking required minimum distributions from your IRA after reaching 70-1/2 since minimum distributions are not required for Roth IRA accounts, although they are by their beneficiaries after the owner's death (assuming the surviving spouse does not roll the money over to his or her own Roth IRA).
- Whether or not you would like to leave assets in a Roth IRA as an income-tax-free legacy to your heirs, if possible.
- The rate of return you expect to earn on your savings before and during retirement.
- How you pay the taxes due on the conversion: either by taking the money from your existing IRA (thus reducing the amount you can convert) or taking it from other assets.

Generally, the longer the period until you start taking the money out of the account and the higher the expected rate of return, the more advantageous it may be to convert at least some of the traditional IRA money into a Roth IRA. That is because the more you can accumulate in the Roth IRA by retirement, the greater the benefit of its tax-free withdrawals.

Although it may be impossible to project, your potential tax bracket in retirement is also important. If your tax rate drops significantly after retirement, it may not be beneficial to make the conversion since you would be paying tax on the current earnings (and deductible contributions) at a higher rate now rather than at a lower rate in retirement.

On the other hand, if your tax rate rises between now and retirement, the conversion could be more attractive since taxes due as a result of the conversion would be paid at the lower rate now, while earnings would presumably be withdrawn tax-free at a time when your tax rate is higher.

OTHER ROTH BENEFITS

In addition to any future earnings growing tax-free, another benefit of a conversion is that the investor (and surviving spouse if he or she rolls over the assets) does not have to start making minimum withdrawals from the Roth IRA at age 70-1/2, increasing the time the assets can continue to grow free of taxes. Also, if you take distributions before age 59-1/2, it may be possible to avoid taxation or penalties with the Roth, since any distributions from a Roth IRA are considered to be a return of your contributions first and then earnings.

For those who plan to leave part or all of their Roth or traditional IRA assets to a beneficiary, the beneficiary may be able to continue to defer taxes on the assets and simply take required minimum withdrawals from the account over the beneficiary's remaining actuarial life expectancy. Beneficiaries can take more than the minimum amount at any time. Most beneficiaries who are spouses roll over the assets they inherit into an IRA of their own instead. However, the Roth IRA provides a potentially significant benefit for beneficiaries, since all the distributions over this extended period can be income-tax free, whereas all earnings and deductible contributions withdrawn from an inherited traditional IRA will be taxable to the beneficiary.

A Roth IRA is one of the most valuable assets a couple can leave their children or grandchildren. The investments are tax-sheltered, the income can be tax-free, and – after the death of the Roth IRA account owner – those who inherit the assets can make withdrawals based on their own life expectancies. Nevertheless, investors must weigh the upfront tax costs against the long-term tax advantages of a Roth IRA conversion. We suggest you consult with your tax professional to see if a Roth IRA conversion is in your best interest. §