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PMFM INC.
Personal Mutual Fund Management

Today we had the largest one day drop in the history of the stock market. The Dow was down 777 points (6.98%); the S&P 500 lost 106 points (8.79%) and the NASDAQ was down 199 points (9.14%).

Stocks were lower most of the day but the sell-off really accelerated when Congress voted down the $700 billion 'bail-out' package. It will be interesting to see where the market - and Congress - go from here, but the question I've been asked most often is, "How did we get in this mess in the first place?"

First, a little background. In 1977, Congress passed the Community Reinvestment Act (CRA) to require banks to make real estate loans in areas they might not otherwise consider. In 1995, some additional teeth were put into the CRA regulations and banks had to step up the effort or else run afoul of the banking regulators.

In 1999, to continue the effort to extend the possibility of home ownership for low and moderate income earners, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") loosened their loan requirements, which gave birth to more adjustable rate mortgages, no documentation loans, lower down payments, etc. (Today we call those riskier loans 'sub-prime'.)

It is important to understand that banks and mortgage companies typically only 'originate' home loans to collect a fee and then sell them. With Freddie and Fannie's lower standards for buying the loans, the mortgage lenders could pay less attention to the borrower's qualifications, write new loans and collect more fees to their hearts content. Wall Street jumped on board and bundled these mortgages into 'packages' called Collateralized Mortgage Obligations and Collateralized Debt Obligations (CMOs and CDOs). They would split these packages into pieces, even get mortgage insurance on some of them to get an AAA rating, and sell them to other investors. This gave banks and mortgage companies another outlet, in addition to Fannie and Freddie, to sell the loans which means they could write even more.

More people were enjoying the American Dream, banks were booking nice fees that helped the bottom line, and Wall Street was making a fortune selling these 'derivatives' that represented a pool of loans. Everybody in the loop was happy as could be . . . while real estate prices were going up.

Warren Buffet once said "When the tide goes out you can see who's been swimming naked." When the real estate market started to soften a couple of years ago, there were definitely a lot of folks feeling pretty naked.

When the real estate bubble began to leak air the situation turned ugly quickly. Homeowners struggling to make their payments started to default in huge numbers, when it was apparent their homes weren't worth what they'd borrowed. That started a chain of events that resulted in the market for sub-prime paper drying up.

One factor that accelerated this problem was a change in the accounting rules that required firms to 'mark to market' their holdings on a regular basis. (Mark to market means 'tell me what it's worth today, not what you expect to get at maturity'.) It was a post-Enron legislative action to create transparency and 'protect' investors, but as these investment banks were forced to continually write down the value of their holdings, they were in turn required to put up more capital. When the appetite for sub-prime loans