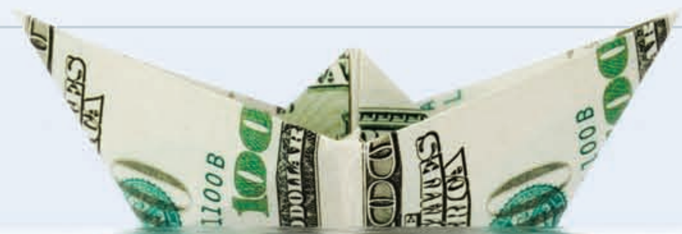
MORE MORTGAGE MELTDOWN

6 Ways to Profit in These Bad Times



WHITNEY TILSON
GLENN TONGUE
T2 PARTNERS LLC

Advance Praise for
More Mortgage Meltdown

"Whitney's presentation makes complex financial concepts easy to understand, and I appreciate that. Despite the gloomy economic forecast, I actually found his calm and rational demeanor very comforting."

—Debbie Ermiger, Hewlett-Packard Company

"Not only is this topic daunting, but it is also somewhat difficult to understand; however, Whitney does a fabulous job of making it both interesting and comprehensible. His careful consideration of the details really provides an accurate, truly expert view of the economy."

—Heba Macksoud

"Whitney Tilson's insights and comments are invaluable."

—Marilyn Tahl

"Whitney Tilson's sobering review of the debt bubble, and what we might expect to see in the next 1 to (gulp . . . 25 years is an excellent reminder that we need to constantly plan and be prepared for potentially ugly scenarios in both our personal and our business lives. Tilson also provides an excellent perspective on the current situation.

"I've found that people tend to accept a situation and find a way to move through it when they have a fuller understanding of what happened and why. Tilson's presentation of what happened offers that 'what' and 'why.'"

—Jesse M. Keyser, *The Motley Fool*

"I found Whitney Tilson's presentation on the mortgage mess riveting as well as frightening. I don't know whether to stuff my mattress or help the economy and buy a mattress! I really appreciated learning what he had to say."

—Elaine C. Sherwood, Customer Experience, Manager,
Sun Microsystems, Inc.

More Mortgage Meltdown

6 Ways to Profit in These Bad Times

Whitney Tilson
Glenn Tongue

John Wiley & Sons, Inc.

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Finally, we'd like to thank our families and friends, whose love, patience, and support make everything we do possible.

Introduction

It was a cold day in early February 2008 as we biked to the Peninsula Hotel in midtown Manhattan to meet Sean Dobson, the CEO of Amherst Securities. We were there because we were intrigued by this e-mail a friend had sent us a few days earlier:

> Sean is the best mortgage technician I know and has developed a unique database that includes virtually all mortgages originated since 1998, sliced by month of origination, product type, and further stratified by a proprietary coding system that picks up loan-level characteristics with unusual predictive capability. He has monthly delinquency and default statistics, new defaults as a percentage of current outstanding and CPR [conditional prepayment rate] stats. Loans can be assigned to securitizations and you can see where you can go from there for RMBS [residential mortgage-backed security] tranches and CDOs [collateralized debt obligations].
>
> He runs a mortgage broker-dealer and advises many hedge funds and institutional accounts on their mortgage-related investments, including CDSs [credit default swaps] and the various indexes. He is definitely someone you should get to know.

Sean presented slide after slide filled with wild, multicolor charts and squiggly lines, explaining them in a strange language we didn't understand (which we now call "mortgagese").

From what little we could understand, the message was clear: The U.S. housing market had experienced a bubble of enormous proportions, and countless mortgages were defaulting at unprecedented, catastrophic rates. More importantly, there was no sign of a letup and, in fact, Sean argued that things were likely to get much, much worse.

We started to ask him a lot of questions, trying to figure out what all the squiggly lines meant and understand terms like DTI, CDX, sTr, cTr, SMM, and vPr. Fortunately, Sean was patient and, as we began to understand mortgagese, our eyes got big and our jaws hit the floor as we realized: Holy cow, he's right! This bubble is much bigger and more far-reaching than almost anyone realizes, and is only in the early stages of bursting.

This conclusion was in sharp contrast to the consensus view among investors, government regulators, and policy makers, who thought that the worst was behind us. It wasn't an unreasonable view, given that almost a year had passed since subprime mortgages had started to default at high rates, defaults in other areas weren't yet at alarming levels, and the fallout seemed to be contained to a handful of firms and funds that had blown up, like Novastar, New Century Financial, and the Bear Stearns hedge funds. But Sean's data told a very different story: that we were in the second inning, not the seventh inning, of the mortgage meltdown.

As we write this book a year later, we're now in roughly the fifth inning, which has important implications for investors (not to mention policy makers, bankers, and CEOs).

Before we met Sean, we'd been following the housing and mortgage markets for years and had long believed that a significant bubble had occurred and was in the process of bursting. Thus, we were skeptical of the calm assurances throughout 2007 and well into 2008 that the worst was behind us that were offered by President Bush, Fed Chairman Ben Bernanke, Treasury Secretary Henry Paulson, the CEOs of financial and

real estate firms, and Wall Street analysts who, with very few exceptions, simply parrot what CEOs tell them. Given our skepticism, by the time we met Sean we'd already sold a number of stocks with exposure to the housing market that had previously been among our favorites, such as USG Corporation and Mueller Water Products, and had shorted a number of financial stocks, including Allied Capital, Ambac, Farmer Mac, Lehman Brothers, and MBIA Inc.

Nevertheless, in February 2008 we were much too sanguine about the economy and the markets and thus had left ourselves dangerously exposed, with a long portfolio nearly four times the size of our short portfolio. Our meeting with Sean was the catalyst for us to do a lot more work.

We went back to the office that day and started digging . . . and digging . . . and digging, seeking to understand the U.S. housing market and what the future might hold. Every data point we uncovered confirmed Sean's thesis, so as we developed greater conviction we began to take action. Within two months, we'd trimmed our long exposure by a quarter and increased our short exposure by nearly a third, such that our longs were only twice as much as our shorts; and we maintained a more defensive position throughout the rest of the year than we otherwise would have.

These steps enabled us to survive the carnage of 2008. A number of the smartest value investors we know lost 40 percent, 50 percent, 60 percent, or more during the year as markets around the world crashed—and we would have likely been in the same boat had we not developed tremendous conviction about how bad the mortgage meltdown would be and acted on it.

With the benefit of hindsight, which is always 20/20, we should have been even more aggressive. In particular, we failed to anticipate how widespread the damage would be. We believed the mortgage meltdown would create a significant economic headwind, to be sure, but thought that the government would throw enough money at the problem to contain it. We certainly didn't foresee the near-Armageddon fallout that instead occurred, so we left our portfolio exposed to many retail and consumer-related stocks, which were crushed. Fortunately, however, we had big gains on the short side such that our main hedge

fund was down less than half of what the S&P 500 declined. We survived the Great Bear Market of 2008—a year I suspect we will tell our grandchildren about someday.

Most investors, having discovered a valuable treasure trove of data like Sean's and coming to firm conclusions with powerful implications for the markets, would have kept this information to themselves. But we didn't. We started shouting from the rooftops—writing articles, speaking at conferences, appearing on television (most notably on *60 Minutes* in December 2008), putting together and widely disseminating a slide presentation with the data we'd collected from Sean and others, and finally writing this book.

Why have we spent so much time and energy being the bearers of bad tidings? In part because, by talking about our ideas, we've gotten a lot of valuable feedback and information. But the main reason is that we feel a duty to teach and share.

Neither of us has a traditional money management background, in which one learns at the feet of a master for many years and only then launches a fund, in the Tiger Cub model (the name given to the many successful hedge fund managers who started their careers by working for famed investor Julian Robertson of Tiger Management). Instead, we are largely self-taught. But that doesn't mean we started from scratch. We owe a huge debt of gratitude to the legendary investors who taught us through their writings and/or public speaking, starting with Benjamin Graham, Warren Buffett and Charlie Munger, but also including Phil Fisher, Peter Lynch, Seth Klarman, Joel Greenblatt, Bill Miller, Marty Whitman, Bill Nygren, Mason Hawkins, and the managers of Tweedy Browne and Ruane Cuniff.

There's a great tradition in the value investing community of teaching and sharing. Having benefited so enormously from it, we wish to continue this tradition.

In writing this book, we're not claiming that we know more about the housing market than anyone else—Sean Dobson has probably

forgotten more than we'll ever know—nor that we were the savviest or earliest investors to figure out what was happening—John Paulson, Seth Klarman, and Bill Ackman, among others, figured it out before we did. That's one reason why they're a lot richer than we are!

But having presented our work dozens of times to thousands of people across the country and all over the world (including Italy, Mexico, and Peru), we think we've figured out a way to present what we've learned so that anyone can understand what happened and why, where we are today, and what the future holds.

The focus of this book is the U.S. mortgage market, the single largest debt market in the world and the one that is the locomotive of the credit crisis. Until the carnage here is dealt with—or simply begins to ease due to the passage of time—it's hard to imagine that the U.S. (and world) economy is going to turn around.

It's important to understand, however, that this bubble was not limited to mortgages but infected nearly every type of debt, and it wasn't just a U.S. phenomenon but a global one.

In the first half of the book, we explain what happened and why, where we are now, and what the future holds. In the second half of the book, after some general thoughts aimed at all investors, we share six in-depth case studies of stocks that we were long or short in the hedge funds we manage as of March 2009. In doing so, we are not trying to give you hot stock tips, but rather hoping to teach you to be a better investor—to share with you how we think about certain companies and investment situations so that you can learn and apply these tools in your own investing career going forward.

Part One

What Happened and Why, Where Are We Now, and What Does the Future Hold?

Chapter 1

What Happened during the Housing Bubble?

Talk to your parents or grandparents about buying their first home and they'll tell you it was the fulfillment of the American dream, a long process that involved years of saving and sacrificing to gather enough cash for the 20 percent down payment. They'll tell you that the day they bought their first home was one of the greatest days of their lives, that it represented more than just a place to live. In fact, that home was the single biggest purchase most would ever make, and it represented stability, safety, and security for themselves and their families.

In those days a mortgage was regarded as a sacred obligation, to be paid off steadily over time. And when it was paid off, there was often a mortgage-burning party to celebrate owning the house free and clear.

Home Prices over Time

Historically, there was good reason to believe that homes represented stability, safety, and security. For more than half a century, home prices had marched steadily upward at a rate exceeding inflation by about one-half of 1 percent annually, with very little volatility, as shown in Figure 1.1.

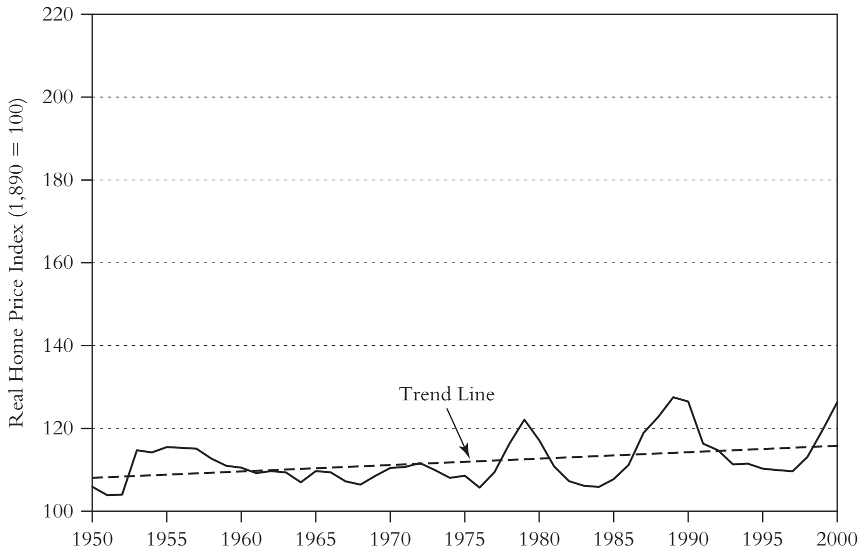

Figure 1.1 Real Home Price Index, 1950–2000
SOURCE: Robert J. Shiller, Professor of Economics, Yale University, *Irrational Exuberance: Second Edition,* Princeton University Press, 2005.

Beginning around 2000, however, home prices started to rise at a rapid rate and became completely disconnected from their historical trend line (shown in Figure 1.2).

There were many reasons for the upward movement, as we'll explain in detail in Chapter 2, but the biggest driver of the housing bubble was the simple fact that the amount an average homeowner was able to borrow to buy a house tripled in a relatively short period of time, as shown in Figure 1.3.

Prior to 2000, the typical borrower could borrow roughly three times his income to buy a house. Figure 1.3 shows that in January 2000, a person with pretax income of nearly $34,000 (the national average) could take out a mortgage of 3.3 times this amount, or $110,000. Of course, the borrower had to have a 20 percent down payment and a decent credit history, and banks were rigorous about evaluating the ability to repay. But all this began to unravel as the years passed.

By January 2004, average pretax income had risen 9 percent to $37,000, but the amount that could be borrowed rose 60 percent

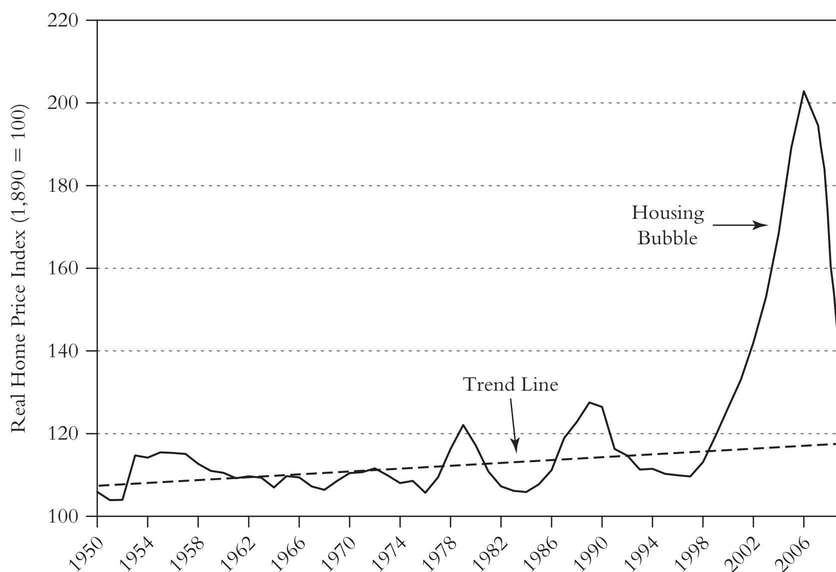

Figure 1.2 Real Home Price Index, 1950–2008
SOURCE: Robert J. Shiller, Professor of Economics, Yale University, *Irrational Exuberance: Second Edition*, Princeton University Press, 2005, as updated by the author.

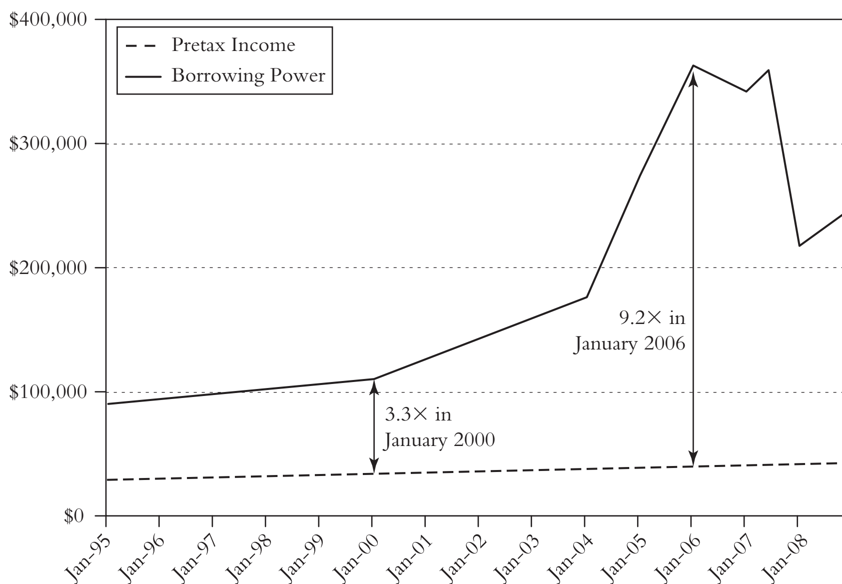

Figure 1.3 Average Income and Borrowing Power
SOURCE: Amherst Securities.

to $176,000, a 4.8× ratio. A year later, the figures were $38,000, $274,000, and 7.2×, and by January 2006, with income of only $39,600, the amount that could be borrowed to buy a house was an astonishing $363,000, a 9.2× ratio. This enormous borrowing power persisted for another year-and-a-half until the housing bubble began to burst in mid-2007.

There were a number of factors, including falling interest rates, driving this threefold increase in borrowing power in only six years, but by far the biggest was that lenders grew willing to lend up to the point that debt payments consumed 60 percent of a borrower's pretax income, whereas historically the permitted ratio didn't exceed 33 percent. Worse, little or no down payment or documentation was necessary, and interest-only loans proliferated.

Suddenly throwing such a massive amount of capital at a relatively stable asset base caused prices to skyrocket, which led to a self-reinforcing cycle: In order to afford a home, prospective homeowners had to borrow more and take on risky, exotic mortgages instead of conservative 30-year, fixed-rate, fully amortizing mortgages. In turn, exotic mortgages and loose lending terms allowed homeowners to borrow much more money, thereby driving prices ever higher.

The bubble manifested itself in different ways in different parts of the country. As discussed later, in inner cities like Detroit, equity-stripping schemes were common; in Florida, Arizona, and Nevada, there was widespread speculation and overbuilding; and in California, which has 10 percent of the nation's homes but is where 34 percent of the foreclosures are happening (44 percent by dollar value), the bubble was primarily an affordability problem. That's not to say there wasn't equity stripping in California's inner cities nor an affordability problem in Florida, but these are the general characterizations.

Figure 1.4 shows what happened to housing affordability in three cities in southern California: Los Angeles, Riverside, and San Diego. One can see that the percentage of households that could afford the average home in these three cities, as measured by the National Association of Home Builders (NAHB)/Wells Fargo Housing Opportunity Index, plunged as this decade progressed, to the point that fewer than 10 percent of households could afford the average home using a standard mortgage.

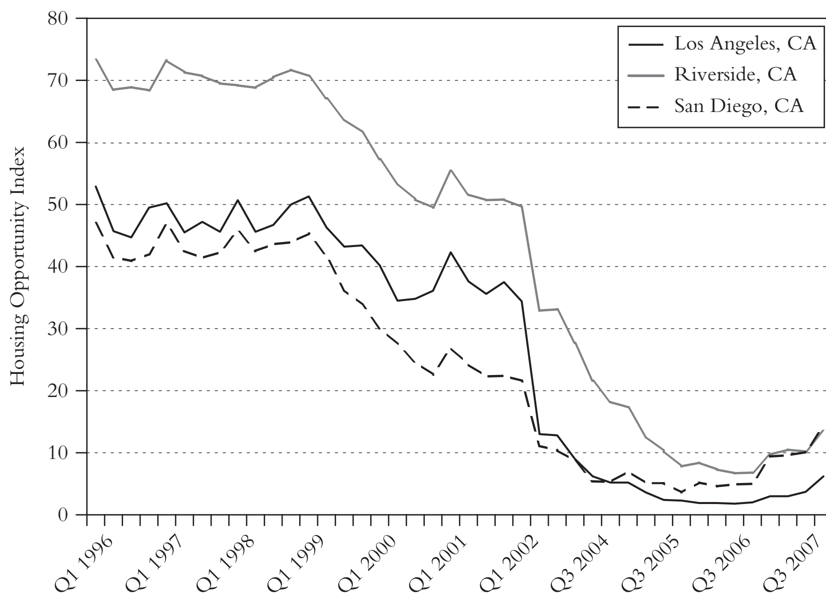

Figure 1.4 Home Affordability in Three Cities

SOURCE: Copyright © National Association of Home Builders 2009. All Rights Reserved. Used by permission. "NAHB" is a registered trademark of National Association of Home Builders. "Wells Fargo" is a registered trademark of Wells Fargo & Company.

Homes as ATMs

Another factor was at work as well: As home prices rose and interest rates dropped, millions of Americans were able to refinance their mortgages at lower rates but also—this is critical—take out *bigger mortgages*, thereby converting the rising value of their homes into cash. Called a cash-out refinancing or refi, this practice soared during the bubble. In total, as shown in Figure 1.5, Americans pulled more than $2.5 trillion out of their homes from 2004 to 2007, fueling consumer spending and accounting for approximately 8 percent of total disposable income during that period.

The combination of these factors meant that Americans were taking on more and more mortgage debt and had less and less equity in their homes, as shown in Figure 1.6. In fact, in 2007, for the first time ever, American homeowners had more debt than equity in their homes.

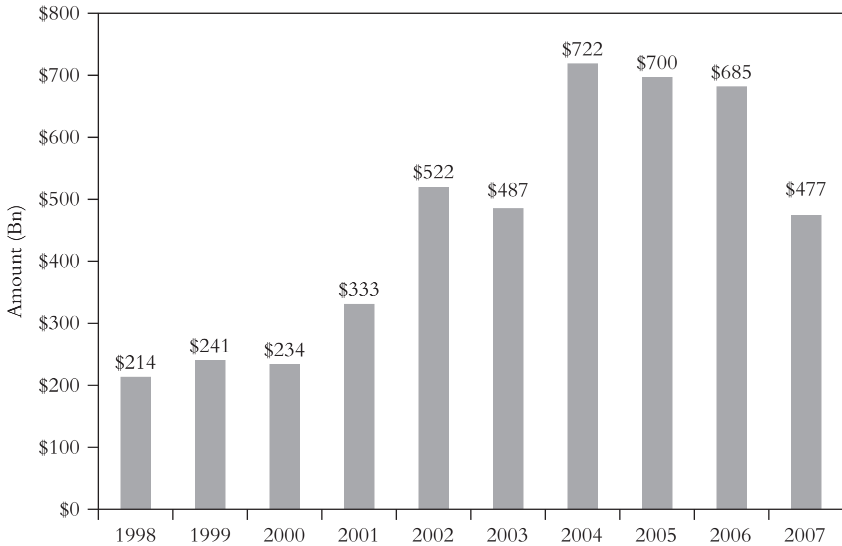

Figure 1.5 Net Home Equity Extraction

SOURCE: Updated estimates provided by James Kennedy in "Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four-Family Residences," by Alan Greenspan and James Kennedy, Federal Reserve Board Finance & Economics Discussion Series (FEDS) working paper no. 2005-41. Home equity extraction is defined in the paper as the discretionary initiatives of homeowners to convert equity in their homes into cash by borrowing in the home mortgage market. Components of home equity extraction include cash-out refinancings, home equity borrowings, and "home turnover extraction" (originations to finance purchases of existing homes minus sellers' debt cancellation).

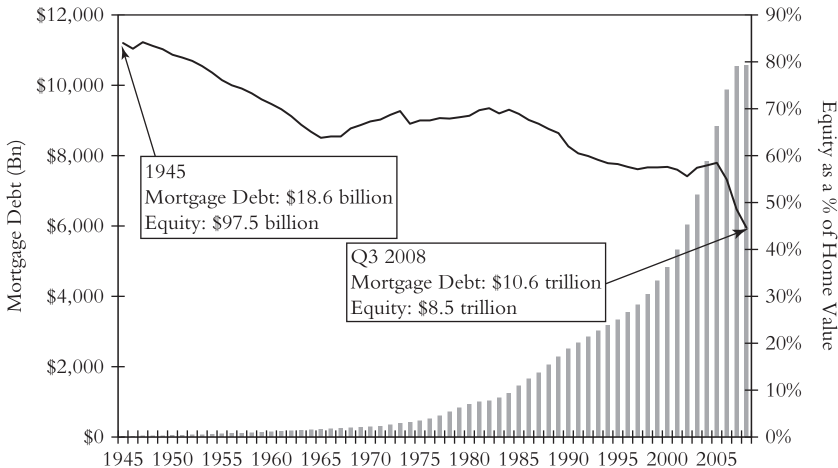

Figure 1.6 Mortgage Debt and Home Equity

SOURCE: Federal Reserve Flow of Fund Accounts of the United States.

The Collapse of Lending Standards

Lending standards collapsed to an almost unimaginable degree during the great bubble, to the point that in some areas if you had a pulse, you could get a mortgage. The collapse manifested itself in many ways.

In 2001, the combined loan-to-value ratio for the average mortgage was 74 percent, meaning the buyer had put down 26 percent of the cost of the home (see Figure 1.7). When doing any kind of lending, it's critical that the borrower has meaningful skin in the game, so there is a strong incentive to repay the loan, even if the value of the asset falls.

Over the next five years, the average loan-to-value ratio rose to 84 percent, meaning that the average borrower was putting down only 16 percent, affording lenders much less protection in the event home prices tumbled. The situation was even more extreme for first-time home buyers, who were putting down only 2 percent on average by early 2007.

Not surprisingly, the percentage of mortgages for which the borrower put no money down—and was effectively getting a free call

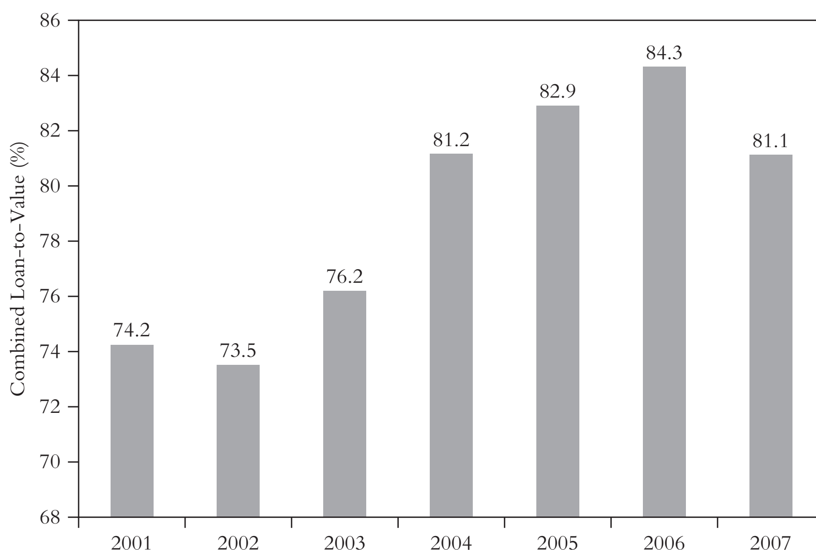

Figure 1.7 Combined Loan-to-Value Ratio
SOURCE: Amherst Securities, LoanPerformance.

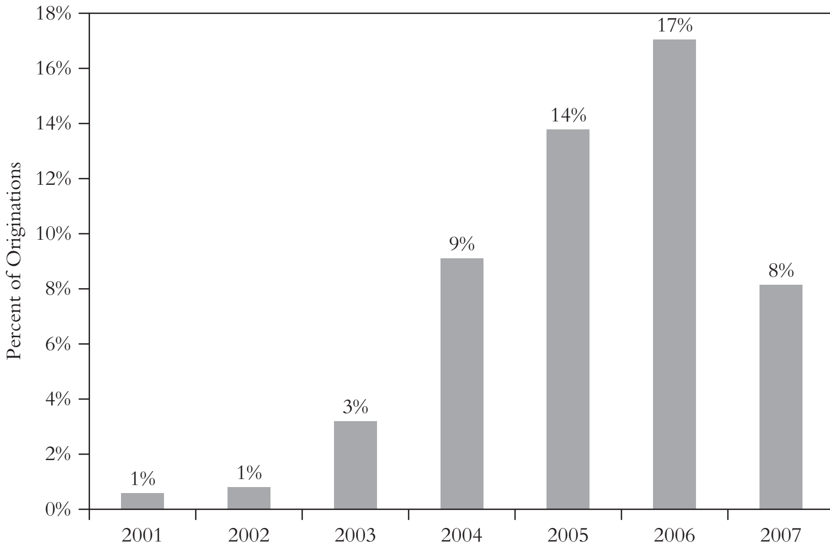

Figure 1.8 Mortgage Loans with 100 Percent Financing
SOURCE: Amherst Securities, LoanPerformance.

option on home price appreciation—soared from virtually nil to one-sixth of all mortgages in 2006, as shown in Figure 1.8.

Another change in lending practices compounded the problem. Historically, a lender was careful to verify a borrower's income and assets by asking to see pay stubs and tax returns—an obvious precaution to ensure that the borrower could afford the payments on the mortgage. There were exceptions made for certain self-employed borrowers like doctors, but this was not common. During the bubble, however, such requirements went out the window as low- and no-documentation mortgages rose to account for nearly two-thirds of all mortgages at the peak, as shown in Figure 1.9. More and more often, a lender simply looked at a borrower's credit score and the appraisal on the house and made the loan based on whatever the borrower stated as income.

Limited-documentation loans were an invitation for fraud, either by the borrower or by the mortgage broker (often both), and fraud is indeed what happened: One study shows that 90 percent of stated-income borrowers overstated their incomes, half of them by more than 50 percent. Another study found that "the average income for stated-income applicants

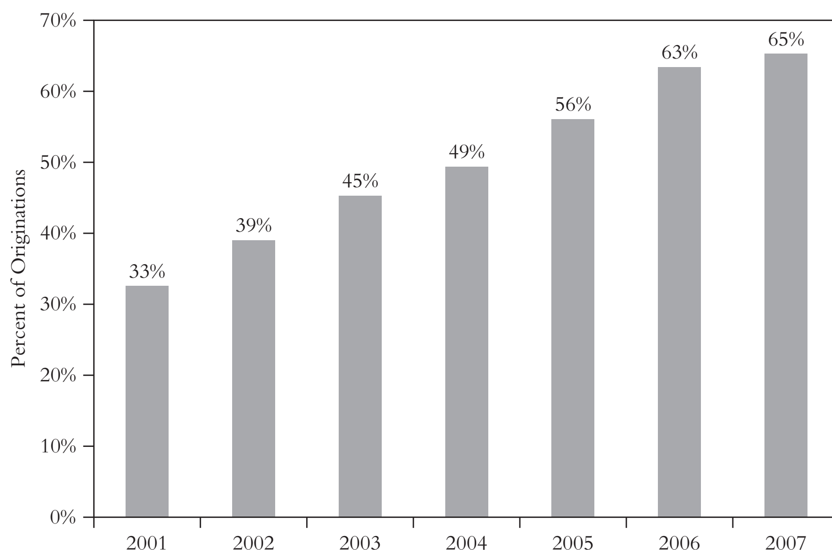

Figure 1.9 Mortgage Loans with Low and No Documentation (aka "Liar's Loans")
SOURCE: Amherst Securities, LoanPerformance.

was 49% higher than the average for fully documented loans and the average income on loans with limited documentation was 92% higher."[1] It's little wonder that these loans are now known as liar's loans.

The most dangerous loans of all are those for which the borrower puts no money down and the lender doesn't bother to check income or assets. Such loans were unheard-of prior to the bubble, but they accounted for 11 percent of all mortgages in 2006, as shown in Figure 1.10.

Historically, one of the most important factors to consider when making a loan was the credit history of the borrower. People who had previously defaulted on many of their loans or bills were rightly considered poor risks and were charged high rates for a mortgage—or, more likely, couldn't get one at any rate.

The most common measurement of a person's credit history is called a FICO score, which ranges from 350 to 850. The median score is 723, and 45 percent of people fall between 700 and 799.[2] Roughly speaking (lenders and analysts use different cutoffs), a score under somewhere between 620 and 660 is called subprime, above 720 is

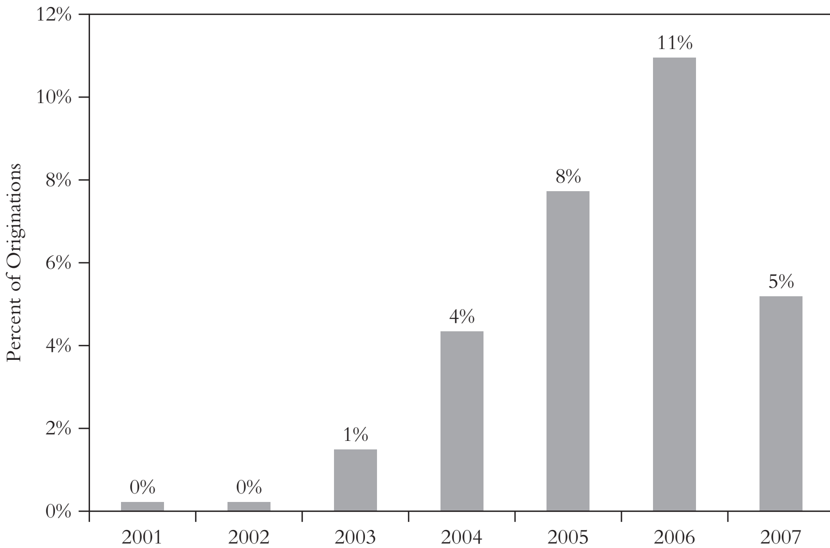

Figure 1.10 Mortgage Loans with 100 Percent Financing and Low/No Documentation
SOURCE: Amherst Securities, LoanPerformance.

considered prime, and in between is called Alt-A, though this category is also defined by limited-documentation loans.[3]

As shown in Figure 1.11, prior to 2002 subprime mortgages were rare, never far exceeding $100 billion worth per year, but then the volume rose rapidly, peaking at roughly $600 billion per year in 2005 and 2006. Subprime had been a small industry generally characterized by reasonable lending standards, but it ballooned to the point that nearly anyone, no matter how poor or uncreditworthy, could get a mortgage, often with no money down and no requirement to document income or assets. Such mortgages were called NINJA loans: no income, no job or assets. True madness.

As much attention as subprime mortgages have garnered in the media lately, it is important to understand that they were just a small part of the marketplace—only 20 percent of the market at the peak of the bubble. Unfortunately, the bubble extended far beyond the subprime arena and, as we discuss later, losses among the other 80 percent of loans that were written during the peak years of the bubble will cause many problems going forward.

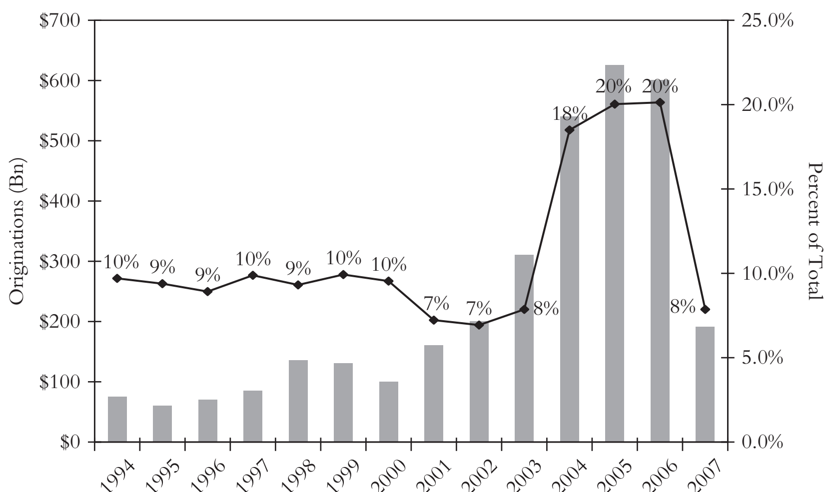

Figure 1.11 Subprime Mortgage Volume and Percentage of Total Originations, 1994–2007

SOURCE: *Inside Mortgage Finance*, Inside Mortgage Finance Publications, Inc. Copyright 2009. Reprinted with permission.

To understand how far lending standards had fallen by the peak of the bubble, let's hear from Mike Garner, who worked at the largest private mortgage bank in Nevada, Silver State Mortgage, who was interviewed by *This American Life* in early 2008:[4]

Alex Blumberg, *This American Life*: Mike noticed that every month, the guidelines were getting a little looser. Something called a stated income, verified asset loan came out, which meant you didn't have to provide paycheck stubs and W-2 forms, as they had [required] in the past. You could simply state your income, as long as you showed that you had money in the bank.

Mike Garner: The next guideline lower is just stated income, stated assets. Then you state what you make and state what's in your bank account. They call and make sure you work where you say you work. Then an accountant has to say for your field it is possible to make what you said you make. But they don't say what you make, just say it's possible that they could make that.

Alex Blumberg: It's just so funny that instead of just asking people to prove what they make there's this theater in place of you having to

find an accountant sitting right in front of me who could very easily provide a W-2, but we're not asking for a W-2 form, but we do want this accountant to say, "Yeah, what they're saying is plausible in some universe."

Mike Garner: Yeah, and loan officers would have an accountant they could call up and say, "Can you write a statement saying a truck driver can make this much money?" Then the next one came along and it was no income, verified assets. So you don't have to tell the people what you do for a living. You don't have to tell the people what you do for work. All you have to do is state you have a certain amount of money in your bank account. And then the next one is just no income, no assets. You don't have to state anything. Just have to have a credit score and a pulse.

Rising Home Ownership

One apparent benefit of what was going on was that home ownership rates were going up substantially, as shown in Figure 1.12. Initially, this

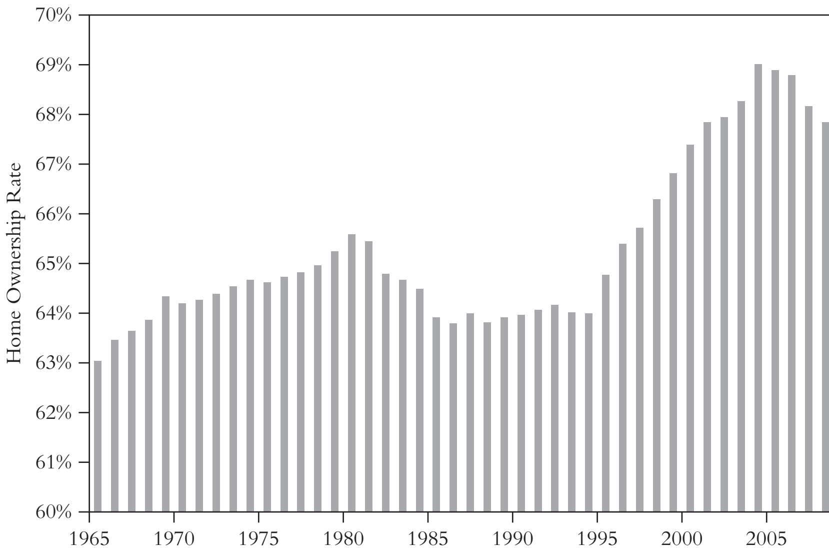

Figure 1.12 Percentage of Households Owning Homes
SOURCE: U.S. Census Bureau.