Proteus Performance Management

PENSION UPDATE

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SUB-PRIME MORTGAGE CRISIS

The market turmoil over the past week has raised many questions regarding the extent of the impact of sub-prime mortgages in the U.S. on world markets.

What are sub-prime mortgages?

Sub-prime mortgages are debt issued to individuals who may not have qualified for typical mortgages because of poor credit history. In return for the 'poorer quality' of the debt, the interest rate associated with the loan would be higher than a typical mortgage. The increased interest rate is required because of the increased risk.

A popular sub-prime loan would involve a low initial rate for perhaps two years, followed by a significantly higher rate thereafter. Some borrowers believed they could simply refinance when the low introductory rate expired and therefore continue to afford the mortgage payments. However, as interest rates in the U.S. have increased significantly over the past couple of years, many of these borrowers find themselves in position where they are unable to refinance and hence are not able to afford their mortgages at the new higher rates and are defaulting on the loan. As these loans started to default, investors began questioning the quality of the debt they held and began to sell off low quality and buy higher quality.

As is often the case, investors are willing to take on more risk when things are good and the 'downside' has not been seen for some time. When the downside does arrive (i.e. the risk that justified the higher yield in the first place) suddenly investors who thought they were comfortable with it, panic and look to sell.

How big a problem is this?

There has been a large impact from a relatively small segment of the U.S. market. Ben Stein of the New York Times commented that the losses in the sub-prime market may amount to between $33bln and $67bln. This in turn startled the U.S. stock market, pushing it down 6.7% which amounts to $1.1 trillion or more than 30 times the losses so far in the sub-prime market[1]*(continued on page 2).*

[1] Chicken Little's Brethren, on the Trading Floor. New York Times August 12, 2007

by: Gord Lewis

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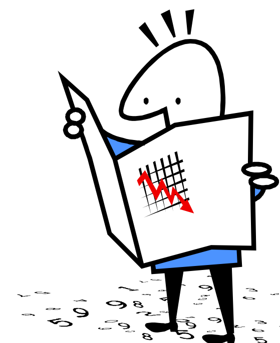
How does this affect Canadian institutional investors?

Sub-prime loans have reached into some Canadian financial institutions in an indirect manner by being 'bundled' with other credit debt (car loans, credit card receivables) and re-sold to investors.

Investment management firm PH&N offered a comment regarding the relationship between the sub-prime situation and its client portfolios by stating "likely the greatest risk to client portfolios, at the total plan level, is exposure to capital market volatility driven by sub-prime fears, rather than direct exposure to sub-prime lending."[2]



Many Canadian financial institutions have been affected to some degree by this situation. With respect to the big banks, the impact is not seen to be material, as commented by the rating agency DBRS "DBRS expects the Canadian banking industry to absorb the losses and maintain its current credit ratings, as a result of: (1) strong pre-tax earnings, which is the first level of defence to absorb higher losses; and (2) being well capitalized. Regulatory capital levels are at historically high levels, and earnings are reasonable diversified at all of the Big Five banks."[3]

Of the major Canadian Institutional investment managers we contacted specifically about their positions in these types of securities, all indicated they either had zero or very limited exposure.

Several managers went out of their way to indicate they are watching some of their high quality holdings that have been impacted in anticipation of buying more of the stock as prices drop.

[2] Sub-Prime Exposure in PH&N portfolios, August 16, 2007, Richard Self, John Skeans

[3] Sub-Prime Exposure in PH&N portfolios, August 16, 2007, Richard Self, John Skeans

How significant is the latest market correction?

We all know stock markets move up and down. In fact it has been said that equity markets tend to move "up by the stairs and down by the elevator."[4] To put the recent stock market drop into perspective, consider the following;

- As at June 30, 2007 the Canadian TSX Index had a four year annualized return of 21.2%. It more than doubled during four year period.
- From its low on Oct 9, 2002 of 5695, the TSX reached 14,625 on July 19, 2007. This represents a 157% increase.
- The Index started the year at 12908 and closed Friday August 17th at 13049 (+1.1%).

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Ted Ransby, Chairman and Chief Investment Strategist of GWL Investment Management echoed other comments we heard by stating that with respect to long-term potential for the markets, "interest rates are still relatively low, world economies are still moving ahead at a solid pace, corporate balance sheets are strong, and price earnings ratios are reasonable when compared to the cost of money."

If you have any questions regarding this or any other investment topic, please contact Gord Lewis of Proteus at (416) 421-3557, ext. 12.

[4] Ted Ransby, GWLIM Market Commentary August 17, 2007

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