

## There Is Never Just One Cockroach

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Dear Subscriber:

I trust you had a happy 4<sup>th</sup> of July weekend and hope that you were able to stretch it into a long weekend with family and friends. 4<sup>th</sup> of July is one of my favorite holidays as we celebrate the uniquely American experiment in democracy that is unprecedented in human history.

Since I last wrote, we've been going 150% at ProfitScore Capital Management.

In just the last few weeks, we recently landed a 30 million dollar institutional relationship and I had some extremely positive meetings in Atlanta with various Registered Investment Advisors, fund of funds managers and broker/dealer firms.

Our multi-manager portfolio platform is generating wide acceptance among financial professionals, and it's always positive when your peers are willing to trust their money and their clients' money with your investment programs.

The markets were relatively quiet last week as everyone fired up their barbeques instead of their laptops. I had a wonderful 4<sup>th</sup> but spent a fair amount of time in front of my computer screen on Thursday and Friday.

In this newsletter, I'd like to share what I see ahead on my economic radar screen.

I'm going to start by rolling up my sleeves and digging straight into the details of the subprime mortgage mess and how it's now affecting the biggest brokerage houses on Wall Street.

The topic is difficult, complex and arcane, but other than that, a lot of fun; but trust me, you'll become an expert at it over the next three years as this growing scandal unfolds.

Terms like subprime, CDO, CDS, Alt-A and other unfamiliar jargon, suitable only for Alan Greenspan and his ilk, will soon be commonplace as this debacle mushrooms into a financial disaster reminiscent of the savings and loan disaster of 20 years ago.

Because, no matter what, as French novelist Alphonse Karr once so famously said, "The more things change, the more things remain the same."

Twenty years ago we saw the "go go" lending years in the savings and loan business where house bankers in Stockton, California, home of State Savings and Loan, were making 7 figure incomes from commissions on their loans, only to see it all implode in a massive government bailout a few years later.

And unfortunately, then, as now, there is never just one cockroach – never!

If you see one on your wall, hundreds more are hiding in the cracks. And I can promise you this; by the time the dust has settled on this issue, there will be thousands of sub prime cockroaches everywhere and you will personally want to squash every cockroach you see with the heel of your shoe.

Here's why:

### **Mortgage Fund Foibles**

To date, more than 50 sub-prime lenders have either disappeared or been bailed out with major injections of capital. According to Bloomberg, roughly 65% of mortgage-backed bonds in an index to track subprime mortgage debt no longer meet the ratings criteria in place when they were sold. And this may just be the beginning.

Last week, a brokerage firm became the first securities industry casualty of the subprime fiasco. After failing to meet margin calls on mortgage-backed security Collateralized Mortgage Obligations (CMOs), BrookStreet Securities collapsed and its offices were closed under the watchful eye of the SEC.

The failure was due to a "notional pricing disparity," a fancy way of saying that the original value placed on the investments plummeted as the subprime market collapsed. And guess what. The company was required to pony up cash they didn't have.

Venerable Wall Street firm, Bear Stearns, managed to avoid a similar fate by injecting \$3.2 Billion (with a capital “B”) to bail out their previously high flying, money-losing mortgage-backed securities hedge fund.

As of the third week in June, S&P has downgraded 45 bonds backed by subprime mortgages and said it may have to reduce ratings on 88 more following similar action by Moody’s the week before.

In May, rating agency Fitch singled out another 35 CDOs in the U.S. “experiencing the greatest stress,” according to Bloomberg, and future downgrades by rating agencies will force hundreds of investors to sell holdings, sending shock waves through the \$800 billion market for subprime mortgage backed securities and \$1 trillion of collateralized debt obligations (CDOs) market.

One mortgage debt specialist estimated that CDOs will lose \$125 billion. Another estimate by Institutional Risk Analytics, a company that writes accounting programs to track these assets estimates that 25% of CDOs are in jeopardy to the tune of \$250 billion.

This kind of situation causes panic and the Bear Stearns hedge fund fiasco is just a hint of the market’s reaction in weeks and months to come.

How bad could it get?

The market of asset backed securities that use consumer, commercial and other loans as collateral has **doubled** to \$10 trillion since 2000 according to the Securities Industry Financial Markets Association. As a point of comparison, the savings and loans crisis that crushed markets in the 1980s and 1990s required the sale of **only** \$452 billion of assets, costing taxpayers \$140 billion to resolve the debacle. BrookStreet Securities was a small firm and the overriding question now is how many larger broker firms and hedge funds await similar fates?

### **Waiting for the Other Shoe to Drop**

An interesting article entitled Investment Landfill: How Professionals Dump Their Toxic Waste on You may shed more light on this question. According to author Paul Tustain, Director of BuillionVault.com, approximately six million subprime borrowers in the United States took out 100% mortgages on homes at the top of the housing market.

Everything was fine as long as home prices were rising, but now with prices falling, defaults are rising. In fact, Ohio Attorney General Marc Dann stated in an interview a couple of weeks ago that 49% of those taking out subprime loans in 2006 failed to make even their first payments!

The problem for institutional investors who have purchased CDOs containing these subprime loans (including hedge funds, banks and brokerage houses) is something any savvy investor well understands – leverage.

For example, if an investor uses 50% margin, it means that he has \$1 of cash invested in every \$2 of stocks in his portfolio. Great while the market is rising since the value of his holdings increases twice as fast. But leverage is a double edged sword. He loses \$2 for every \$1 invested on the way down.

Hedge funds use anywhere from 5 to 15-times leverage which means for every dollar of cash invested, they were able to purchase \$5 to \$15 worth of CDOs. As the value of these mortgage-backed securities falls, hedge funds and brokers need to come up with many times more money than originally invested to meet margin calls.

All but the very biggest won't be able to step up to those obligations without a serious cash injection so bankruptcy is the only other option left on the table. And bankruptcy is a dirty word in global equity markets.

<b>Overall Largest CDO Managers by Size of Liabilities</b>			
<b>Year-end 2004</b>	<b>Sept. 30, 2005</b>	<b>Manager</b>	<b>Liabilities (Billion \$)</b>
1	1	CW Group Inc.	\$22.00
2	2	Babson Capital Management LLC	\$12.53
17	3	Duke Funding Management LLC	\$10.45
6	4	Credit Suisse Alternative Capital	\$9.97
5	5	BlackRock Financial Management Inc.	\$9.49
3	6	Brightwater Capital Management	\$9.10
4	7	Pacific Investment Management Co. LLC	\$8.84
13	8	Vanderbilt Capital Advisors	\$6.57
8	9	Prudential Investment Management	\$6.53
12	10	Deerfield Capital Management LLC	\$6.05
7	11	GMAC Institutional Advisors	\$6.03
9	12	ACA Capital Holdings	\$5.87
–	<b>13</b>	<b>Bear Stearns Asset Management</b>	<b>\$5.77</b>
23	14	Sankaty Advisors LLC	\$5.54
11	15	Fortress Investment Group	\$5.46
14	16	Highland Capital Management L.P.	\$4.98
10	17	Structured Credit Partners LLC	\$4.96
16	18	INVESCO Senior Secured Mgt Inc.	\$4.89
15	19	Western Asset Management Co.	\$4.73
18	20	RiverSource Investments LLC	\$4.67
–	21	Aladdin Capital Management LLC	\$4.28
–	22	Paramax Capital Group	\$4.27
20	23	C-BASS	\$4.27
–	24	Declaration Management & Research LLC	\$4.14
25	25	Ares Management LLC	\$3.94
<b>Total CDO Liabilities of Top 25 firms =</b>			<b>\$175.33</b>
Source - Standard & Poors <i>Structured Finance CDO</i> - <a href="http://tinyurl.com/3cvxyr">http://tinyurl.com/3cvxyr</a>			

Table 1 – Ranking of the largest CDO collateral managers showing increases in market share from 2004 to 2005. As of September 30, 2005, 28 collateral managers represented approximately 50% of the U.S. CDO market on the basis of outstanding liabilities rated by S&P.

The Bear Stearns hedge fund \$3.2 billion bailout was relatively small (see Table 1). The top CDO collateral manager ranked by Standard & Poor's in 2005 had CDO liabilities totaling \$22 billion or nearly 4-times total liabilities for Bear Stearns. The top 25 firms represented less than 50% of the total CDO market in 2005 which means that the other 50% or more in CDOs are held by small firms with greater total liabilities than listed in Table 1.

As we see above, Bear Stearns moved to 13th place from out of the top 25 places in 2005. Duke Funding Management LLC registered the fastest liability growth rate as the firm moved from 17<sup>th</sup> to 3<sup>rd</sup> in 2005 with liabilities more than double those of Bear Stearns.

However, 2006 experienced the greatest issue of CDOs with more than \$500 billion being issued last year alone according to a study by Professor Joseph Mason of Drexel's Business School and Joshua Rosner of research firm Graham Fisher and Company. Given the dynamics of the housing correction curve (in the S&P Case-Shiller Home Price Index), companies that took on the greatest CDO liabilities at the top of the housing market in 2006 are at greatest risk.

### **Crash Comparison**

We have already mentioned the losses involved in the savings and loan crisis of 20 years ago.

Remember the collapse of Long Term Capital Management in 1998? As we learned later, it threatened the stability of all major global financial markets, and only thanks to intervention by the Federal Reserve was a meltdown avoided. According to Paul Tustain, it required a bailout of \$3.65 billion and the fund was leveraged to around \$125 billion.

How big a meltdown could central bankers handle today? No one really knows since it largely depends upon how much farther home prices fall and the strength of the economy during this correction.

### **Devil in the Derivative Details**

According to Tustain, the credit default swap derivative market represents an even larger risk than the subprime market.

According to data from the Bank of International Settlements, global over-the-counter derivatives totaled \$465 trillion (estimate) as of June 2007. But credit default swaps (CDS) are the fastest growing segment of the derivative market. From 2005 to 2006, total dollar volume of CDSs doubled to nearly \$35 trillion.

Credit default swaps act as insurance policies against default. One party (buyer) pays a fee to another party (seller) in return for compensation in the event of default of a bond or other instrument. Over the last few years, investors have lined up to back these insurance

policies to insure instruments (like CDOs) against failures in return for a premium. But due to competition for these investments, premiums have shrunken to nearly zero compared to more established instruments like Treasury bonds.

In other words, investors have been willing to accept premiums of as little as 1-2% more than that offered by a T-bond to assume large and in many cases unknown risks – unknown because the instruments they backed are new and have not collapsed before and because due to the complexity of the instruments no one really knows what they are insuring.

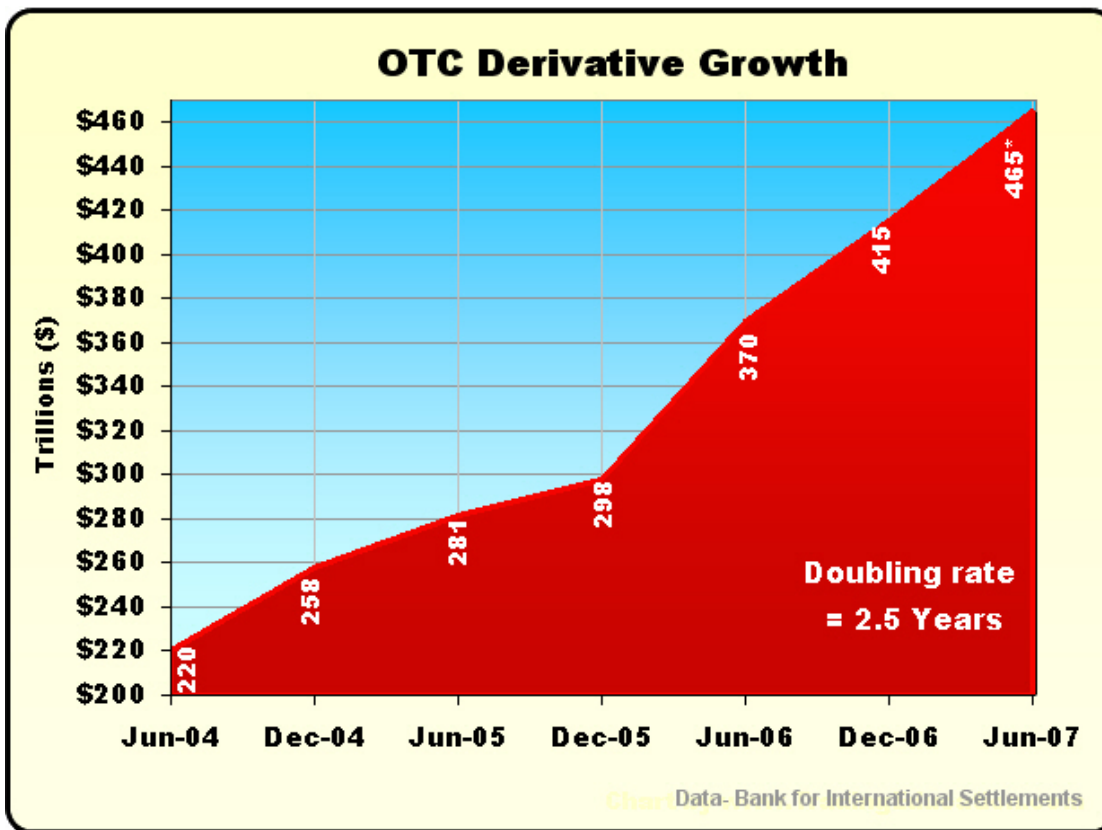


Figure 1 – The total value of over-the-counter derivatives has more than doubled over the last three years and is on schedule to hit \$500 trillion in 2008.

When the insured bonds default, the policy backer must ante up for the full value of the loss. As investors who backed UK insurer Lloyds of London in the early 1990s learned, it was penny wise and dollar foolish to risk everything on policies about which you had little understanding. Many investors who had put up homes, stock portfolios and other assets as collateral lost everything when losses began to mount – all because they wanted to earn an extra 2-3% on their investments.

Stay tuned next time when we will take an in-depth look into the derivatives market and what a collapse in any one sector could mean to global financial stability. We will also look at why current house price data including the highly respected Case-Shiller home

price index may be misleading and what it means for buyers, sellers, lenders and mortgage-backed securities investors in the months ahead.

## **ProfitScore Performance versus Our Benchmark Indexes**

**Overall, I was very satisfied with our portfolios' performance during the volatile month of June that saw losses in all the major indexes.**

All of our portfolios held up extremely well in an environment that was decidedly negative for most fixed income and equity indexes.

Based strictly on performance, our most aggressive portfolio, The Expedition, once again led the pack in overall performance and against its benchmark. Although Income Builder incurred the largest loss for the month, it shined the brightest due to its above benchmark performance in the highly volatile and decidedly negative fixed income sector.

Our other two moderately aggressive portfolios, The Guardian & Harmony Plus, were basically flat for the month versus a loss for the S&P 500 Index.

### **Our performance Year to Date across all portfolios makes me want to dance a jig.**

For a detailed analysis of our portfolios' performance, please click on the links provided below:

[http://www.profitscore.com/income\\_builder.pdf](http://www.profitscore.com/income_builder.pdf)

[http://www.profitscore.com/harmony\\_plus.pdf](http://www.profitscore.com/harmony_plus.pdf)

[http://www.profitscore.com/the\\_guardian.pdf](http://www.profitscore.com/the_guardian.pdf)

[http://www.profitscore.com/the\\_expedition.pdf](http://www.profitscore.com/the_expedition.pdf)

#### **If You Are a Client, Don't Be Confused.**

*Actual management and performance fees are incurred monthly but are deducted from client accounts in the first month of every quarter (January, April, July, and October). For performance reporting purposes, we deduct fees monthly as they incur and not quarterly as they are reflected in client statements. It all washes out in the end but this may cause your account performance to deviate from our published performance reports on a month-to-month basis. To be conservative, we also deduct the maximum fees we charge from our performance reports and your actual overall fees paid may be less than our maximum.*

## **A Multi-Manager Case Study**

June also provided a crystal clear case study of why you never put all of your eggs into one basket. In June, our single best manager had his single worst month in the last three years. Since our managers' information is confidential, let's call him Manager A. If I would have shown you Manager A's monthly returns in April, you would have wanted me to allocate all your money to his strategy because the guy was such a rock star.

But, low and behold, Manager A had a very difficult month in June; his first in many months, but, because of our multi-manager allocation techniques, investors in this portfolio didn't feel a thing.

And simply put, that is the real power of the ProfitScore multi-manager portfolios. Like a 4 wheel drive car, when one wheel falters, the other 3 pull you up the hill to your financial destination.

We call this critical risk mitigation technique "Uncorrelated Redundancy" and you'll hear us repeat that concept again and again as it's the bedrock of our philosophy.

One of our core disciplines developed into our multi-manager allocation algorithm is that your portfolio is only as strong as your weakest link.

The unknown quality of incorporating this discipline is that you never know where that link is and when it is going to fail. Also, it's not uncommon for traders to have completely different opinions on the same market while both producing consistently positive returns. This can happen for many reasons, and it happens often.

And that's why I incorporate Uncorrelated Redundancy into all of our multi-manager portfolios. In this case, our other redundant manager had his best month in the last three years in the same month Manager A had his worst. As a client of ProfitScore, you received the direct benefits of our multi-manager portfolios. You neither gained nor lost any money in this one allocation stream so you win by not losing.

## **Tactical Trading Summaries**

### Index Advantage:

Our cumulative long/short index allocations have ranged from flat, net short to net long. The last two weeks were volatile at best and our talented team rose to the challenge by significantly outperforming the overall equity market with 1/3 of the volatility.

In the most negative days, our exposure was flat to net short, and during the biggest up days, we printed money. As of close of business Friday, our long/short exposure was a little long going into Monday but mostly flat.

### Strategic Balance:

Our rotational strategies neither helped nor hurt our performance for the month. It was split down the middle with half of the strategies ending up positive while the other half being equally negative. We have some of the best managers on the team in this pillar and expect great production moving forward.

### Income Advantage:

Many investors don't realize the risk associated with fixed income investments. On a percentage basis, fixed income declines and increases less than equity investments, but they possess more volatility than the average investor expects or understands. Investors also get confused by the inverse relationship with returns. When interest rates increase, the value of bonds decreases and vice versa.

Interest rates saw their biggest rise in several years only to bounce off resistance and drop back down only to once again rise. It was a rollercoaster as the ever flattening yield curve appears to be on the rise. If we break through recent overhead resistance, expect a painful rise in mortgage interest rates. (If this happens, many folks in the subprime market will have their back against a wall of very sharp knives) Our high yield exposure continues to be flat and our long/short government bond exposure changes day-by-day. Our exposure to the dollar is also negative. Overall, our traders are doing a good job of adjusting to volatile changes taking place across the full spectrum of the yield curve.

Exposures Change Often.

*Some of our traders trade daily, some weekly and some monthly, but when you aggregate all this activity into one account, some change almost always occurs on a daily basis. In other words, any portfolio's composition today can be completely different tomorrow. All of our portfolios are invested across one or more of the three pillars of strength highlighted above. Each pillar is comprised of several different strategies/managers that work together in a synergistic fashion. To enhance the consistency of performance, all strategically built and tactically managed ProfitScore portfolios leverage the uncorrelated talents of multiple investment managers to mitigate the manager specific risk found in all single manager portfolios.*

## **A Cool Place on a Hot Boise Day**

I mentioned earlier that I really enjoyed the 4<sup>th</sup> of July weekend. You might have read about the heat wave sweeping the West, but in Boise, we're living it. All week it has been over 100 Degrees Fahrenheit, more than 30 Degrees Celsius for our European friends, so the family and I thought it would be a great idea to float the Boise River on the 4<sup>th</sup> of July.

It was a good idea, so good, in fact, that we shared the river with 10,000 of our closest friends. But nevertheless, there isn't a colder, deeper, wider, cleaner, white water river flowing through the heart of any American city that I know of.

And my wife and little girls and I had a great time, the kind of carefree time we'll all remember many, many years from now. We jumped off things we weren't suppose to jump from and swung from ropes we weren't suppose to swing from as we made our refreshing voyage. Mom is never too happy about seeing her girls jump off high objects into the river, but the girls just love it. And I did, too, as I tried to soak up every moment because I know that, sadly, little girls grow up way too fast.

I hope you had a wonderful holiday, as well, and that you have big plans for the rest of the summer.

I'm looking forward to a great summer professionally and personally, and I have to tell you that there's nothing I like to do more than talking about the merits of absolute return investments and multi-manager portfolios.

If you share my passion for sophisticated investments that are perfectly designed for the complex world we live in, please give me a call and we can spend some time bending each others' ears and complaining about the heat.

Working to grow your wealth,

John M. McClure  
President & CEO

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