



# Quarterly Update April 2007

Brattleboro ♦ Burlington ♦ Rutland ♦ St. Albans ♦ Stowe

## Singing the Subprime Mortgage Blues

Up until a couple of weeks ago, you'd probably never heard of Accredited Home Lenders or NovaStar Financial, but these companies have been making headlines of late. They are part of the subprime mortgage lending industry, and of the top 25 companies in this industry, these are the only two remaining. The others have either gone bankrupt, been sold or are currently up for sale. So what is a subprime mortgage lender, why are they in trouble and why is any of this significant?

A subprime mortgage lender is a specialty finance company that originates mortgage loans to individuals who would not qualify for a traditional mortgage loan due to low credit scores. Many of these loans tend to be adjustable-rate mortgages with very low initial interest rates, allowing these borrowers to take on debt they could not ordinarily afford. These loans are then sold to banks and intermediaries who in turn repackage these loans into high yielding, mortgage-backed securities (MBS) and re-sell them to investors.

As interest rates on these loans were reset to higher levels and the substandard borrowers found it difficult to meet ever increasing monthly payments, default levels increased. Forced to increase reserves in the face of swelling defaults, the lenders saw profits

shrink. The banks, now reluctant to buy any loans as the MBS market dried up, stopped lending money up front to the subprime lenders. With bad debts increasing and no liquidity, subprime mortgage lenders were left with few options.



Market bulls will argue that subprime loans make up only about 12% of the total mortgage loans outstanding, and that not all subprime loans will result in foreclosures. The impact on the broader housing market and the economy will be minimal because total losses as a result of foreclosures will be a tiny percentage of outstanding mortgage debt and an even smaller share of the economy. Furthermore, the average American has plenty of equity in their home, which will serve as an insulator. Others, who look at the situation less favorably, argue that while subprime lending only accounts for 12% of total mortgage loans, it accounted for 20% of new loans originated in 2006. Also, many of the subprime adjustable-rate mortgages originated in 2004, when rates were at historic lows,

and will reset this year at much higher rates, likely resulting in increased foreclosures. Delinquencies are also on the rise in prime adjustable-rate mortgages due to the much higher reset rates. As a result of the increase in delinquencies, regulators are calling for tougher lending standards, requiring that borrowers be able to afford the higher rates likely to appear after the "teaser" rate expires.

For the economy, the subprime delinquencies could be just the tip of the iceberg. The losses from foreclosures won't bring the economy to its knees, but the tightening of credit caused by this could threaten future economic growth. Countrywide Credit, a large mortgage originator, recently said that 60% of its customers applying for hybrid adjustable-rate mortgages would fail to qualify under the new lending standards. So with foreclosures on the rise, and fewer qualified buyers, it appears likely that the already weakening housing market will weaken even more.

Although the situation warrants close vigilance, at this time our long term strategy will remain unchanged. We do believe, however, that the sub-prime lending crisis could create an opportunity to purchase selected well run companies at a discount.

While walking on the beach, have you ever experienced the intense focus of looking for just the right shell and the rush you feel when you find one? If so, welcome to Peter Sherlock's world. Peter, who runs his own investment advisory firm, Sherlock Investments, is a director of our company and, as a member of our Trust Investment Committee, plays an important role in our investment process.

Peter was born in Barre Vermont in 1960. Early on it became evident that what he most liked to do was pick stocks. Certainly, he must have been influenced by his father, a stock broker, to acquire such focus so early in life, but it was his mother's personality, an inveterate reader, that shaped his appetite for the dense prose of proxy statements. Single focused, while working part time in high school at the First Vermont Bank, he would pester the trust officer for his stock picks.



By the age of 16 he had already learned a valuable lesson in investing first hand. Just after selling Twentieth Century Fox, the company released Star Wars. Although he had tripled his money, he would have made ten times his investment had he continued to hold. So Peter says he learned the meaning of the old Wall Street adage "Sell your losers, and let your winners run". To be sure, tripling your investment wasn't a bad return and we think Peter is one of those fortunate ones who experience painless lessons.

After graduating from Spaulding High School, he majored in Finance at the University of Vermont, and true to form, worked for an investment firm part-time. Upon graduation he went to work for the Randolph National Bank. His goal was to work

## COLLEAGUE PROFILE



PETER SHERLOCK

in the Trust Department at First Vermont Bank and, when a job became available two years later, he made the move. While at First Vermont he acquired an MBA and the Chartered Financial Analyst designation and, at the extraordinarily early age of 26, became their Chief Investment Officer in 1987. Shortly thereafter, the common trust fund that he managed was rated the best performing bank common fund in the nation.

And yet, within a year of such a noteworthy achievement, Peter left to start his own firm. It was ordained. Peter's objective

early in life was to be self employed. He only wanted to do two things: find undervalued stocks that would perform well and deal directly with the client. For him, everything else was a distraction.

So he spends his days reading financial reports for work and evenings reading financials reports for fun, and gets a rush when, after screening the numbers, everything else is right about the company. Like other "Value Investors", most everything else about the market is a distraction. It is his focus and confidence that picking good stocks will survive overall distress in the market that makes him such a valuable asset to our Company. So as some of us fret on the impact of the subprime mortgages on the market, Peter remains calm and focused.



So his world is not unlike looking for the perfect shell.

Peter lives in Brattleboro with his wife and two children. They are not distractions, and you can be sure that he stops looking for shells whenever they are around.