Sand Spring Advisors LLC

Updated Fibonacci Rhythms

by,

Barclay T. Leib

August 22, 2007

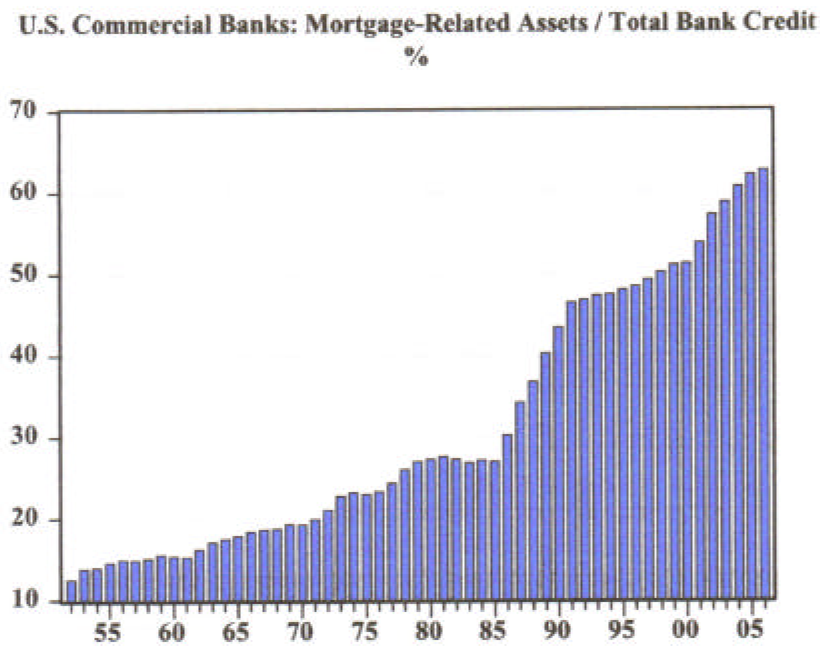
Some of the events of July and August in financial markets came as no surprise to us; others did.

On the pages of Sand Spring letters we have certainly spoken often in the past of the risks to mortgage-related companies such as Countrywide, Washington Mutual, MBIA, Ambac, and PMI. Indeed, in our letter of April 8, 2007, we wrote:

> Similar to Countrywide, Washington Mutual – in its effort to continue to grow even as the housing market became overpriced for many of its potential customers, and traditional mortgage margins eroded as interest expenses increased – specifically embraced "option income ARMs." Option income ARMS are like subprime mortgages in drag. They may have been sold to a slightly higher clientele than sub-prime loans, but they typically are issued with low teaser rates for the first year or two that adjust upwards thereafter. The most popular feature is the "option" which allows the borrower to choose each month between paying the fully amortizing normal mortgage payment, the interest-only payment, or a below rate "cost of funds" payment that makes the loan negatively amortizing. Previously, home buyers were typically allowed to qualify for these loans based on the lowest payment options.
>
> While Washington Mutual may claim only a 10% exposure of its portfolio to sub-prime lending, about 30% of Washington Mutual's originations and the same portion of loans on its balance sheet are option income ARMs. Back in 2005, 43% of first time buyers put no money down for their house, and 2005 was also the biggest year for option ARM loan issuance. This was not a problem initially when home prices went up, but it is now. Indeed, doing the simple math, it is easily possible that many homeowners now owe 10-15% more principal on their mortgages than their home is worth. In 2004 default rates were low and only 1% of Washington Mutual's option income ARMs were in negative amortization. In 2005 loans in negative amortization jumped to 55%, with some estimating that by 2006, 70-80% of these option income loans became negative amortizing. This negative amortization effectively equated in 2006 to $1 billion of non-cash income on Washington Mutual's income statement, and represented approximately 20% of WM's reported pretax earnings. Do investors in WM understand that in lieu of earning real interest, that their bank is becoming a larger and larger property owner each

and every day, and that some of the property that they own may no longer be worth the price on WM's books? Apparently not, as Washington Mutual as late as mid-2006 called option ARMS its "flagship product" which it was trying to increase, even as it also reduced provisions for mortgage defaults. Is WM the next Enron house of cards in the works?

What other problems lurk in the land of bankers given the record high exposure by the U.S. banking community to commercial and residential mortgages, as shown on the chart below (courtesy of Northern Trust)?



Source: Northern Trust

OK – so we were a tad early. Credit spreads may have hit their historic tights near our February 24, 2007 PEI cycle date, but it took until July 2007 for the U.S. mortgage market to come noticeably undone. By the time the mortgage meltdown finally hit in full force, it felt almost like a well advertised slow-motion melt that had always been there, but only suddenly gained investor attention.

As we speak, the slow melt goes on. What has historically been "real earnings" and what has simply been "accrued assumed present discounted earnings" from mortgage origination and servicing companies is an open question. Countrywide and others may easily have already booked years of "assumed servicing income" on the "assumed life" of mortgages that, in the end, won't be around very long to service. In addition, as the mortgage paper that they originated turns sour, some mortgage originators may also face future lawsuits regarding past origination practices and stand accused of potentially having broken HUD mortgage origination rules.

Consider the Bloomberg article below about Wells Fargo that someone sent to me this morning regarding the general issue of "quality of earnings" within the mortgage sector:

Wells Fargo Gorges on Mark-to-Make-Believe Gains: Jonathan Weil
2007-08-22 00:02 (New York)

Commentary by Jonathan Weil

Aug. 22 (Bloomberg) -- There's the kind of earnings investors can take to the bank. And then there's the kind the bank can show to investors.

Word to Wells Fargo & Co. investors: Beware the second kind.

Last quarter Wells Fargo reported record net income of $2.28 billion, up 9 percent from a year earlier. Read the footnotes to its latest quarterly report, though, and you will see a new term in accounting lingo called ``Level 3'' gains. Without these, the financial-services company's earnings would have declined.

So what are Level 3 gains? Pretty much whatever companies want them to be.

You can thank the Financial Accounting Standards Board for this. The board last September approved a new, three-level hierarchy for measuring ``fair values'' of assets and liabilities, under a pronouncement called FASB Statement No. 157, which Wells Fargo adopted in January.

Level 1 means the values come from quoted prices in active markets. The balance-sheet changes then pass through the income statement each quarter as gains or losses. Call this mark-to-market.

Level 2 values are measured using ``observable inputs,'' such as recent transaction prices for similar items, where market quotes aren't available. Call this mark-to-model.

Then there's Level 3. Under Statement 157, this means fair value is measured using ``unobservable inputs.'' While companies can't actually see the changes in the fair values of their assets and liabilities, they're allowed to book them through earnings anyway, based on their own subjective assumptions. Call this mark-to-make-believe.

Antennae Up

``If you see a big chunk of earnings coming from revaluations involving Level 3 inputs, your antennae should go up,'' says Jack Ciesielski, publisher of the Analyst's Accounting Observer research service in Baltimore. ``It's akin to voodoo.''

For San Francisco-based Wells Fargo, whose stock is up 5 percent this year at $37.37, last quarter was a veritable mark-to-make-believe feast.

About $1.21 billion, or 35 percent, of its $3.44 billion in pretax income came from Level 3 net gains on the $18.73 billion portfolio of residential mortgage-servicing rights that Wells Fargo marks at fair value. These assets, known as MSRs, consist of rights to collect fees from third parties in exchange for keeping mortgages current, by doing things like collecting and forwarding monthly payments.

Wells Fargo's July 17 earnings release didn't mention Level 3 items. This isn't how the second-largest U.S. home lender wants investors to parse its earnings either.

Hurting Earnings

Instead it stresses a metric called ``market-related valuation changes to MSRs, net of hedge results,'' which was minus $225 million last quarter. Spun this way, it looks like changes in the servicing rights' values actually hurt earnings.

To get that figure, the company first broke the $1.21 billion of net gains on MSRs into two parts.

Part one was $2.01 billion of gains ``due to changes in valuation model inputs or assumptions.'' Part two was $808 million of fair-value declines from changes related to the servicing rights' expected cash flows over time. (All figures are rounded.)

Next, Wells Fargo took the first part -- the $2.01 billion in gains -- and netted it against $2.24 billion in fair-value losses on certain ``free-standing derivatives.'' The company says it uses these derivatives as ``economic hedges'' against changes in MSR values, although they don't qualify for hedge accounting under the accounting board's rules.

The Rub

Here's the rub: The footnotes show the vast majority of the $2.24 billion in derivative losses were Level 1 or Level 2, while the $2.01 billion in MSR gains were all Level 3.

In other words, it's a safe bet the losses were real, while the gains had all the substance of a prayer. Indeed, Wells Fargo said in its Aug. 6 quarterly report that ``the valuation of MSRs can be highly subjective and involve complex judgments by management about matters that are inherently unpredictable.''

Moreover, to get to minus $225 million for ``market-related valuation changes to MSRs, net of hedge results,'' Wells Fargo excluded the other $808 million in MSR losses, meaning these fair-value changes weren't hedged at all.

In an e-mail, Wells Fargo spokeswoman Janis Smith Appleton said ``it would be inaccurate to characterize one component of our servicing revenue for the quarter in relation to our total results.'' She said that's ``because it would ignore the effect'' rising interest rates had ``on both the increase in fair value of our residential MSRs as well as the corresponding net derivative losses associated with the economic hedges of our MSRs.''

Real Stretch

Inaccurate? No. The real stretch is calling these derivatives hedges.

Nobody forced Wells Fargo to start running quarterly fair-value changes for MSRs through its income statement. The accounting standard that let it do so, called Statement 156, gave it a choice.

SunTrust Banks Inc., by comparison, elected not to. Why? ``In my mind there is no effective hedging strategy out there that captures all those risks that would move in offsetting directions to MSR,'' says Tom Panther, SunTrust's chief accounting officer. So, SunTrust waits until the servicing rights are sold before recognizing any pent-up gains.

MSR values normally rise when interest rates do, because fewer customers refinance and prepay their mortgages. At some point if rates rise too high, though, delinquencies on adjustable-rate mortgages could soar, as customers' rates reset, pushing MSR values down.

With mortgage markets now crashing, SunTrust looks like it made the more prudent choice. Yet in the lunch buffet of generally accepted accounting principles, both companies' approaches are permitted.

Someday, Wells Fargo investors may regret this.

(Jonathan Weil is a Bloomberg News columnist. The opinions expressed are his own. Click on {LETT <GO>} to comment on this column and write a letter to the editor.)

The drama is sure to continue for years, and for what it is worth, we agree with author Jonathan Weill that Wells Fargo – despite popping to new highs over recent days -- is a stock to stay away from on the long side. Who knows what its "real" earnings really are.

What we did not expect in August 2007, however, was that the second area of contagion would be quant market neutral hedge fund managers. Such managers typically run sophisticated algorithms to limit market directional, sub-sector, and capitalization exposures while working to maximize exposure to certain fundamental criteria as well as to price momentum. Because these managers are typically quite diversified and market neutral, they apply leverage to their portfolios to achieve an attractive annual return profile.

Under normal circumstances of increased equity volatility and individual equity price dispersion, quant managers usually do wonderfully. Such was certainly the case back in 2000-2002 as the NASDAQ tech bubble came undone and retail investors ran for the exits. During that era, astute quant managers stood ready to pick up the pieces of the market's wild flailings.

But August 2007 brought something quite different: quant managers tripping over themselves. The way that we understand this story, Goldman Sachs' Global Alpha and Global Equity Opportunity Funds (historically somewhat more volatile and aggressively leveraged than many other quant funds, and allowed to have survived that way by high-net worth clients that trust Goldman and don't know any better) were the "bad boys" who panicked first and started to unwind their quant exposures – worrying about incoming September redemptions. "Good stocks" were sold, and "bad stocks" previously held short – all on effective leverage -- were bought back. Initially, other quant models would have faded this type of market behavior, but apparently the urgency of Goldman's liquidation process overwhelmed these other quants. A second multi-billion dollar statistical arbitrage fund run by Highbridge (owned by JP Morgan) started to do poorly, and for risk management reasons, started to de-lever as well. Another firm in California, Algert Coldiron was forced to start delevering. Then one by one, others threw in the towel – each individually trying to do the prudent thing when their models suddenly were not working, but all effectively "snowballing" the overall impact on the market. Losses over a three day period of -5% to -25% hit the entire statistical arbitrage and quant market neutral sectors. Crazy individual stock behavior resulted where "bad stocks" stocks like Vonage vaulted, but more fundamentally sound stocks like Ingersoll-Rand fell from grace. Multiplied again and again over hundreds of stocks globally, tons of small losses were created, all then magnified by the use of leverage.

What is the lesson from this event? In our estimation it is the story of some of the smartest people on Wall Street creating great products, but then ruining them by allowing the dollars allocated to such strategies to become too large. Over the past two years, two of the biggest quant firms, D.E. Shaw and Highbridge, both grew from around $6-8 billion under management to $35+ billion under management. The entire quant market neutral sector grew to easily have over $1 trillion in levered money at risk. Everyone focused on quant managers picking up the nickels and dimes left behind by un-savvy and inefficient retail investors, and if there was a worry at all, it was that the increased asset sizes allocated to quant market managers might be making markets so efficient that quant managers would suffer return compression. To a certain extent, they did – particularly as market volatility compressed – so many firms added a dose more leverage to compensate. Notwithstanding, everyone was rooting for higher volatility to open up more trading opportunities, but nobody ever considered that such volatility might actually emanate from (or at least be exacerbated by) the quant market neutral managers themselves being forced to unwind their positions.

The underbelly of this strategy has now been exposed. To create any meaningful returns, managers must lever up quant strategies to be 300% long by 300% short, but as they attract more and more assets, the mere existence of such leverage means that there is potentially horrific exit skid if all the quant managers run to de-lever at the same time.

In our humble opinion, the quant models *will* work over time. The academics behind the models are *not* flawed. It's just that these models will also become their own worst enemy at times when fund redemption and de-leverage logistics intervene. Without the use of leverage, the models are too boring. With the use of leverage, the models are too periodically unstable. But there is no ongoing emergency. There was simply a short-term leverage unwind, and if investor redemptions follow (as they likely will), most managers will likely fund such redemptions by simply allowing their leverage to creep higher once again.

Ironically – what is Wall Street's perceived solution to the quant malaise? Why, raise more money of course! This is exactly what this strategy area does not need -- August having clearly demonstrated that the dollar size of quant money already matters too much relative to available market liquidity.

Sand Spring itself -- within its modest alternative investment business -- plans to quietly de-emphasize its allocation to this space. Given the now evident push-pull between needed leverage and yet the risk of periodic de-levering, we doubt if quant trading will ever fully recover to its earlier 2000-2002 glory days. And if the strategy can only limp to muted returns over time, with the periodic risk of an explosion, why bother being involved here at all?

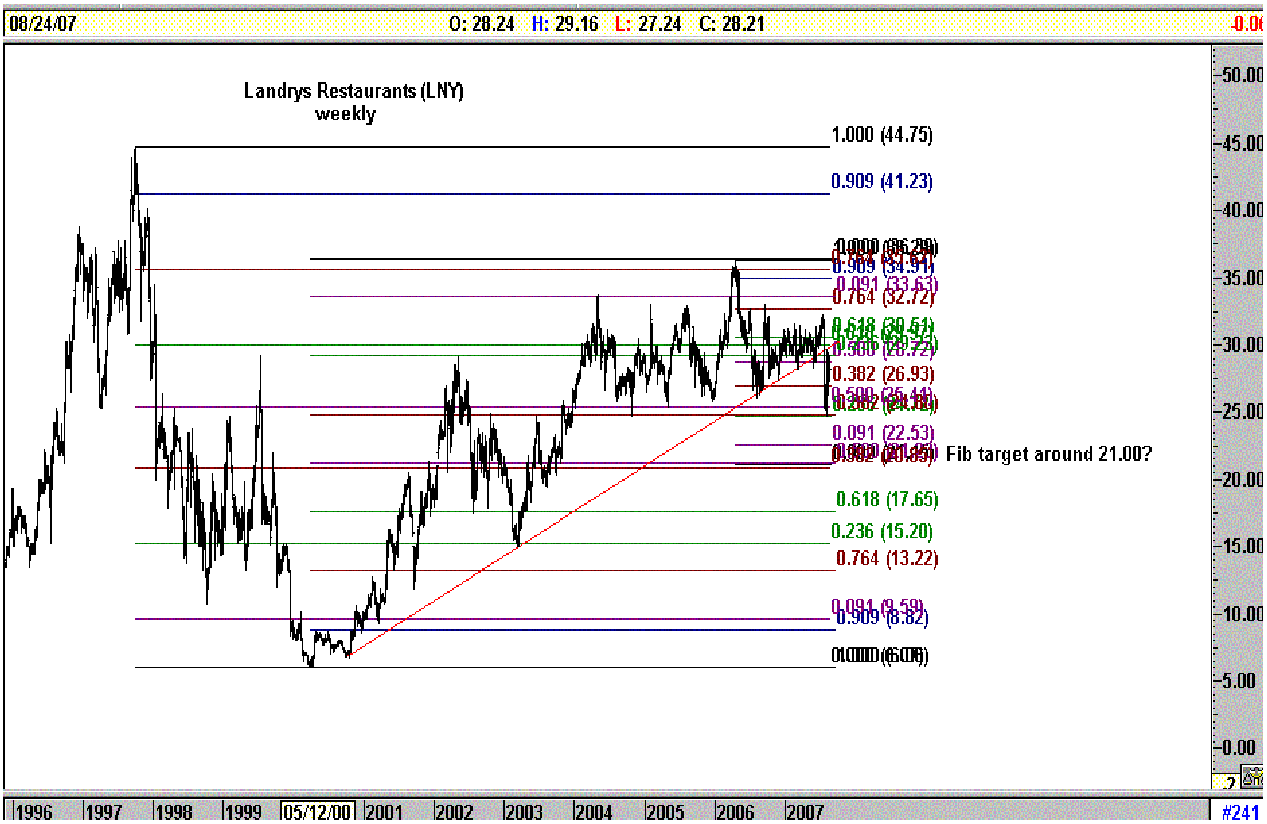
And then of course, as a third part of the August contagion, credit markets seized up, and normally calm commercial paper and bank loan markets hit sudden pockets of reinvestment disinterest. Excessive LBO funding commitments by the banks, and general leverage of bank loans perceived to be "safe" on a corporate credit basis hurt the maneuverability of many participants once again.

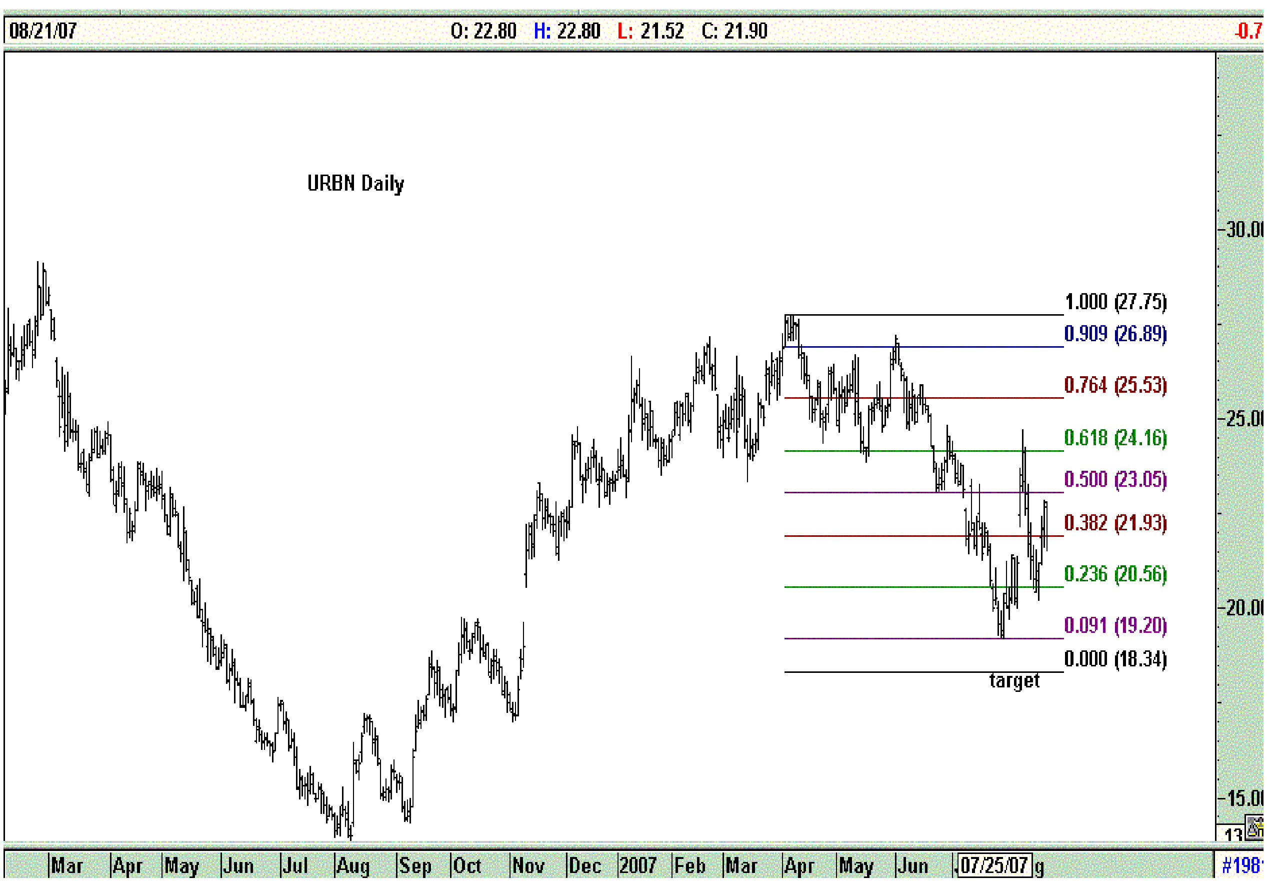
Leverage is certainly a nasty beast when it cuts two ways in this fashion. But alas, the Fed injection of financial system liquidity did come to the short-term rescue here. Financial firms are unlikely to default on any of their respective obligations anytime soon.

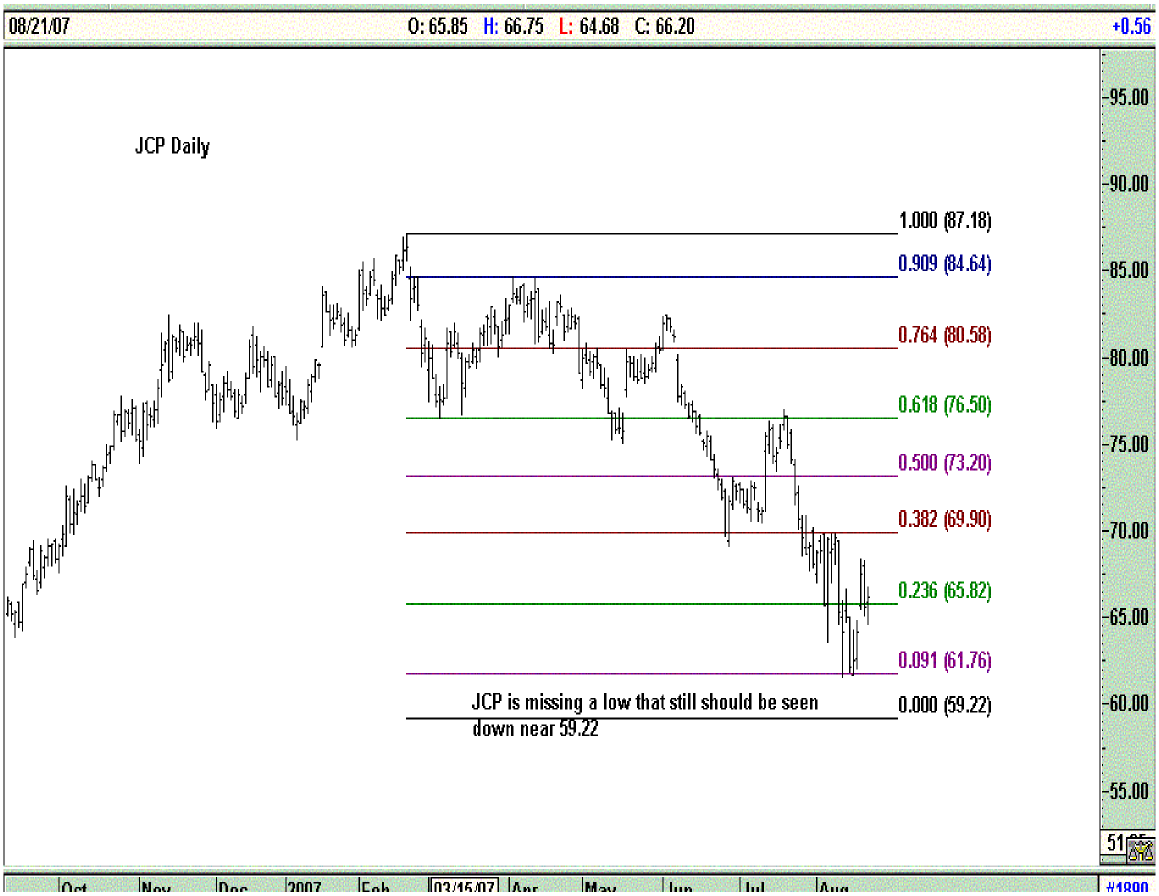
But while the Fed can temporarily help fix Wall Street's malaise, it may have a harder time fixing the overall consumer malaise. Higher gas and heating oil prices, higher healthcare and education costs, and the demise of cash-out mortgage financing -- all are the bigger factors to the consumer, and no change in the Fed Funds rate by 50 or 100 or even 150 basis points is going to have that much impact on the consumer's wallet.

Thus, as a general thought, the time may easily have come to rotate out of financial stock shorts and into consumer stock shorts. Watch for emptier parking lots at local malls as an anecdotal sign to go this route. One might also want to watch for foot traffic in discretionary food restaurants to also finally fall.

Landrys Restaurants (LNY) is one stock where we see a clear $21 downside Fib target. J.C. Penny's (JCP) and Urban Outfitters (URBN) also appear as two vulnerable retailers – at least for one more new low.







But will America still be able to scrape its way to buying the niftiest new gadget – namely the iPhone? Will flat screen televisions still sell? Yes, technological advances will likely carry onwards, even as the demand for more traditional consumer apparel and discretionary restaurant spending may stumble.

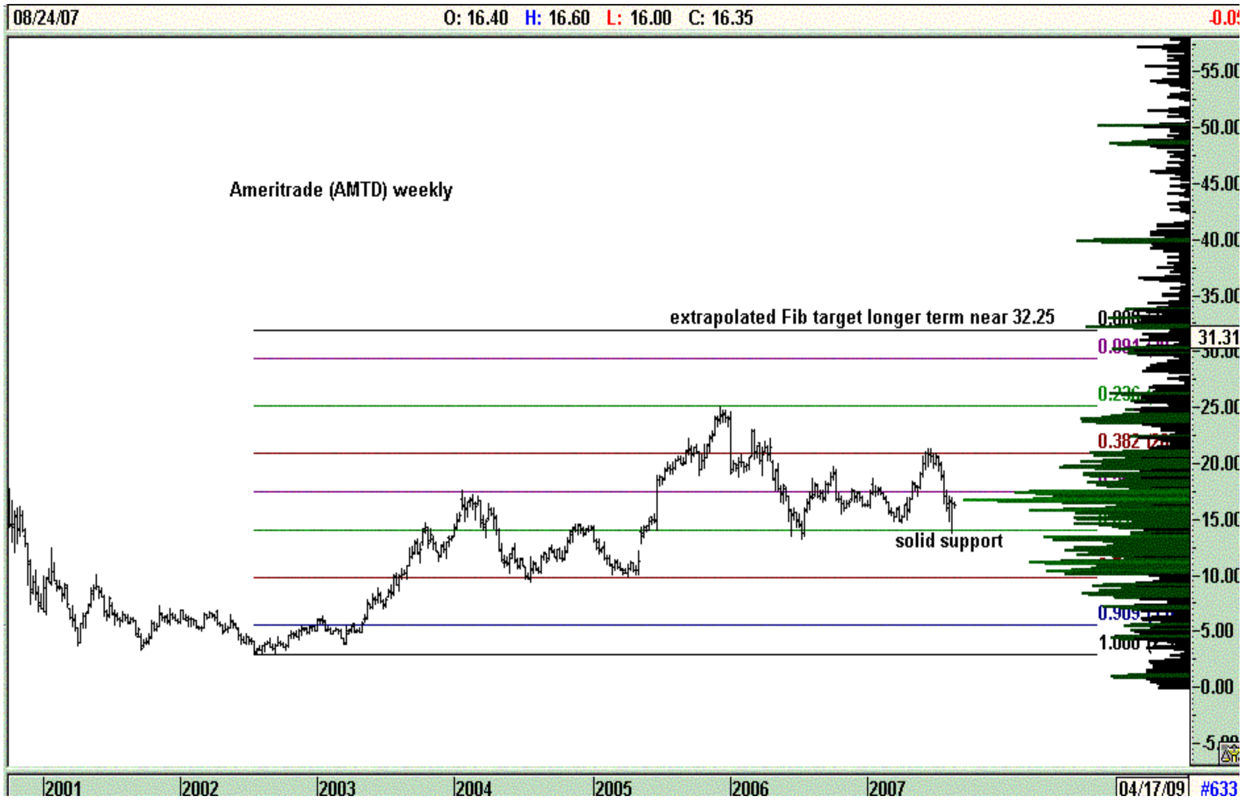
The NASDAQ may easily continue to outperform the more financially-packed and consumer-laden S&P 500. Indeed, we actually expect such a path given the respective Fibonacci rhythms of these two markets whereby the July highs of the S&P 500 look nice and tight at 1555.90, but the NASDAQ 100 may have left a missing "natural attractor high" not yet touched up around 2090.

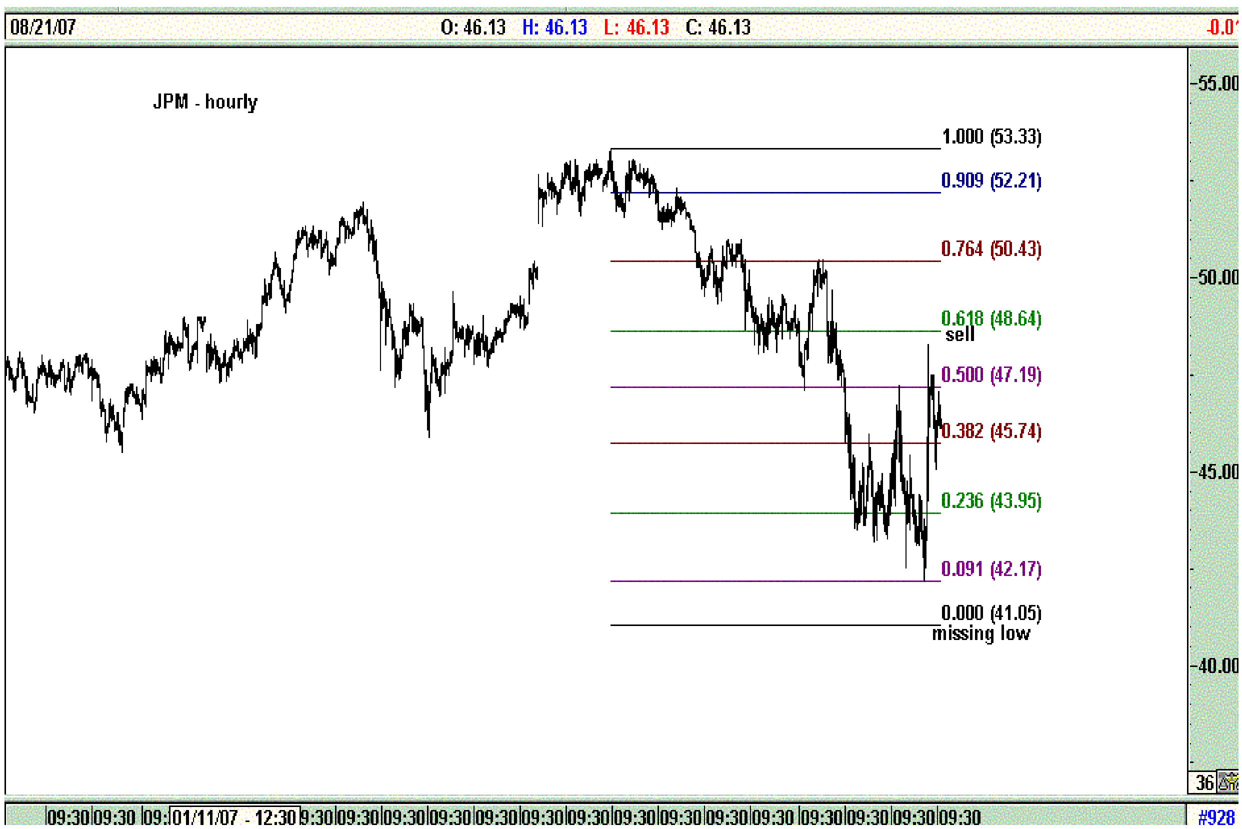
More specifically, when we drill down and look at the chart patterns of three individual tech stocks such as AAPL, WFL, and GLW, they <u>all still look bullishly</u> poised on a Fibonacci rhythm basis.

08/24/07
O: 123.96 H: 128.96 L: 120.50 C: 127.06
+5.00
AAPL
One missing new high near 163.16
0.000 (163.16)
0.091 (148.95)
0.236 (126.31)
0.382 (103.51)
0.500 (85.08)
0.618 (66.65)
0.764 (43.85)
0.909 (21.21)
1.000 (7.00)
200.00
150.00
100.00
50.00
0.00
2001
2002
2003
2004
2005
09/23/05
2006
2007
#821

08/24/07
O: 55.22 H: 59.16 L: 54.00 C: 59.01
WFR
weekly
longer-term target
0.000 (110.93)
0.091 (100.96)
short term target
0.091 (80.26)
0.236 (71.81)
0.382 (69.07)
0.382 (63.30)
0.618 (49.54)
0.618 (43.21)
0.764 (41.03)
0.909 (32.58)
0.909 (11.32)
1.000 (1.35)
60.74
2001
2002
2003
2004
2005
2006
2007
10/03/08
#691

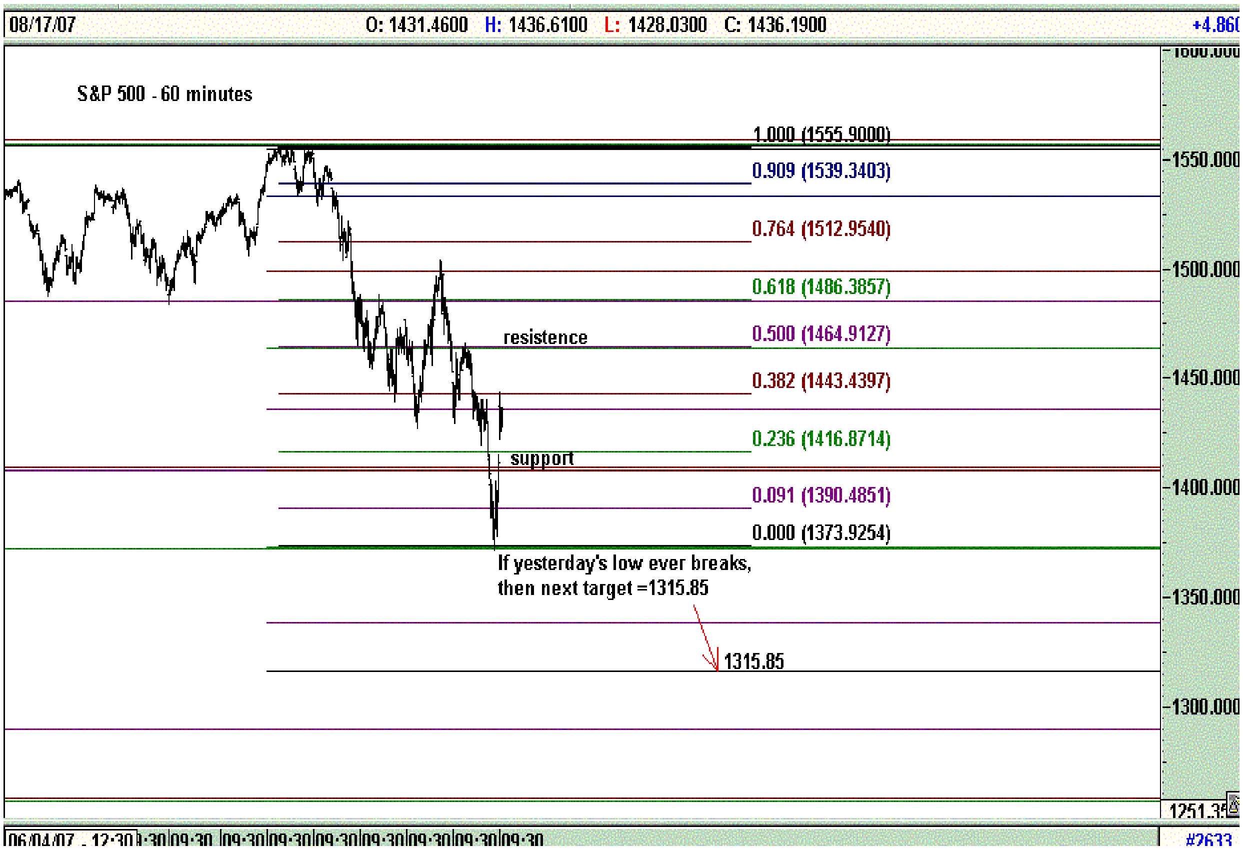
Meanwhile, within the financial sector, we love the spread of being long Ameritrade (AMTD – a retail broker that should benefit from higher trading volumes, with AMTD also being a potential takeover target), while running short JPM (owner of somewhat defamed Highbridge hedge fund experiencing the quant problems described above).





These are just our personal views that fit the Fibonacci rhythms that we see. These perspectives are not meant as investment advice. As always, do your own homework and analysis, and invest in a manner consistent with your own financial position.

Lastly, where the wider equity indices go is more of an open question. We face a potential Bradley Turn date later this week that might be significant as either a high or a low. Our next PEI minor 4-3-month cycle date won't hit until November 12, 2007, and we honestly have no idea what this date might bring. The S&P in the very short-term looks stuck to our eye between 1407 and 1465, even if it may have a soft underbelly for an eventual slide to 1315-1316 region.



In terms of the heavens, astro-analyst Arch Crawford cites the period around the August 28th lunar eclipse as a "scary" one, with nasty aspects continuing across the Labor Day weekend and into early September. Perhaps this will be a retest of recent lows. Crawford was certainly hot recently when he called for July 26-27th period to mark "the end of an era – a more comfortable era evolves into a more dangerous one." Within the predicted period of decline, he also adroitly predicted August 9th to represent a short term pop in prices, but advised that it would likely be "all down hill from there for stocks, economic reports, at to month end and beyond." The mid-August spike in the chart above of the S&P 500 back above 1500 for one brief moment occurred exactly into the August 8th-9th window.

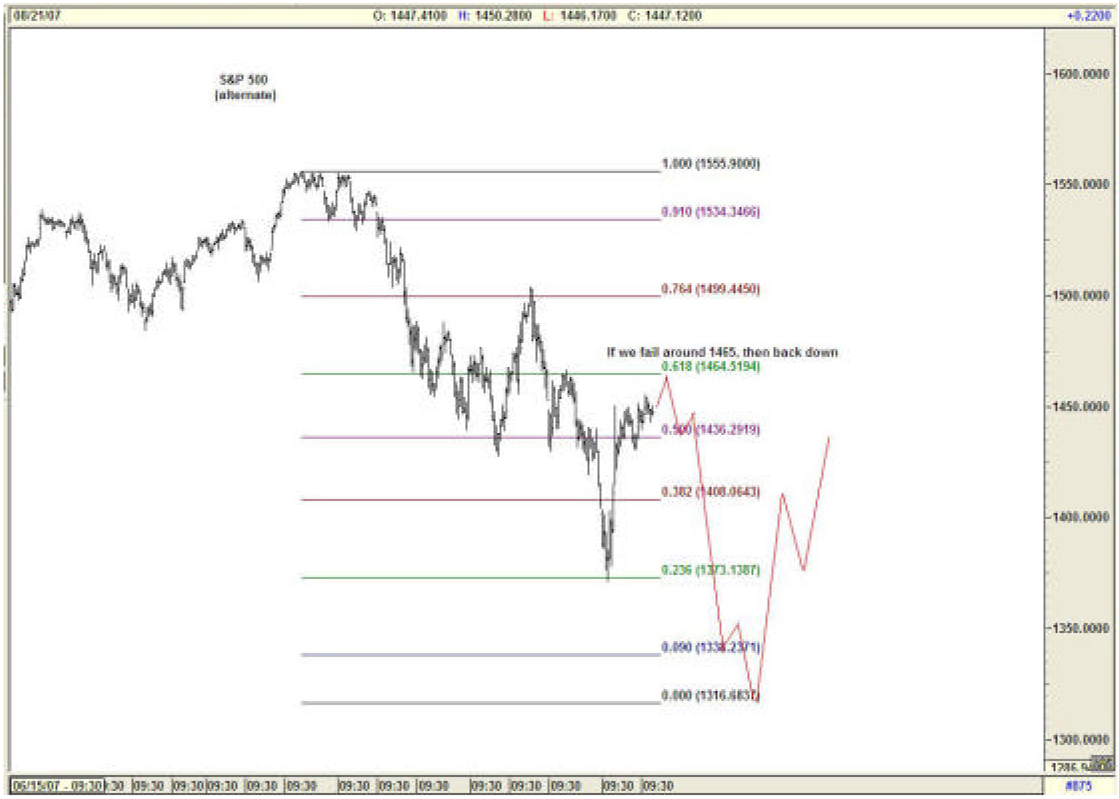
So at the risk of sounding more wishy-washy than we usually are, let us present two sets of potential paths for the S&P 500 and NASDAQ 100.

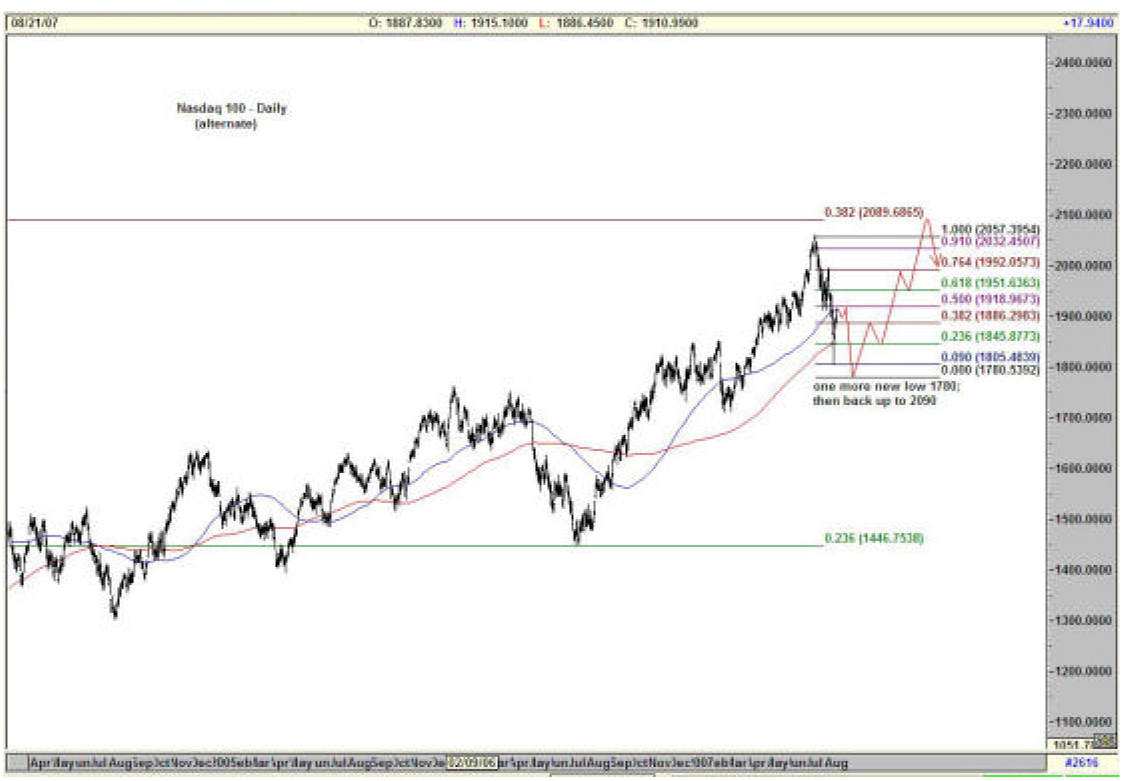
Path one assumes that the market can overcome short-term upside resistance at 1465 on the S&P, and then goes on to form the second shoulder of a Head & Shoulders topping formation over the coming months against stiffer 1486-1487 resistance, while over this same period of time, the NASDAQ vaults to one more marginal new high. Thereafter, both markets slide.


08/21/07
O: 1444.5500 H: 1455.3200 L: 1439.7600 C: 1447.1200
+1.5700
S&P 500 - daily
h
0.000 (1557.2764)
0.090 (1486.3448)
0.236
0.382 (1256.5452)
0.500 (1163.6492)
0.618 (1070.7531)
0.764 (955.8140)
0.910 (840.9535)
1.000 (770.0219)
1900.0000
1800.0000
1700.0000
1600.0000
1514.4218
1400.0000
1300.0000
1200.0000
1100.0000
1000.0000
900.0000
800.0000
11/25/08
#3330


08/21/07
O: 1887.8300 H: 1915.1000 L: 1886.4500 C: 1910.9900
+17.9400
Nasdaq 100 - Daily
0.382 (2089.6865)
0.236 (1446.7538)
2400.0000
2300.0000
2200.0000
2100.0000
2000.0000
1900.0000
1800.0000
1700.0000
1600.0000
1500.0000
1400.0000
1300.0000
1200.0000
1100.0000

Path two might fit Crawford's heavenly portents a bit closer. It would call for the market to fail around 1465 on the S&P over coming days, and then experience one more immediate slide to around 1315. This view is shown on the hourly chart of the S&P below. 1780 would be an equivalent possible downside target on the NASDAQ 100. Only after this last immediate slide, would stocks rally back. This is not our preferred view, but it is possible, so we present it as an "alternate count." Stay tuned to the website for further updates.





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