DiMeo Schneider & Associates, L.L.C.

Third Quarter 2007 Knowledge College

The Credit Crisis of 2007

During July and August, the markets experienced a sudden and severe repricing of risk that caused the value of many asset-backed securities (primarily those comprised of subprime mortgages) to spiral downward. The fallout led to central banks around the world, including the Federal Reserve, taking action in attempt to restore liquidity to the markets.

What is a subprime mortgage?

A subprime mortgage is generally characterized as a loan to borrower who has a weak credit profile - typically determined through the borrower's FICO score.

For several years now, these loans have been packaged into asset backed securities (ABS) and collateralized debt obligations (CDOs). Investors' appetite for these securities grew stronger in recent years as these securities offered higher yields at seemingly very low risk. High credit ratings assigned by the ratings agencies provided further comfort to investors.

What went wrong?

- **As the real estate market began to slow down in late 2005, underwriting standards on many loans deteriorated while the market's pricing of these securities continued to imply rosy expectations.**

  Loan originators began extending credit to people with poor credit history and low credit scores, with no income verification required. These loans were often structured with no or low down payments, high loan-to-value ratios and introductory teaser rates that would reset almost certainly higher in a couple of years.

- **Subprime mortgages started coming under stress as the teaser rates reset higher and home prices stagnated. By the end of August 2007, ratings agencies had downgraded or placed under review more than $125 billion in subprime asset-backed securities**.

  A ripple effect began with the downgrades. Prices fell and levered investors were forced to sell to meet margin requirements and the spiral continued, creating fear and increased volatility. Ratings agencies continued the downgrades and the selling broadened to other areas of the market as investors looked to reduce risk and hedge their positions.

► **Volatility in the equity markets spiked to its highest level in more than 5 years and the Federal Reserve stepped in and cut the discount rate (charged to member banks on loans) from 6.25% to 5.75%.**

The disruption spread to other areas of the fixed income markets that had been considered high-quality, such as short-term commercial paper, where liquidity dried up. Overnight lending rates increased sharply and resulted in many higher quality money center banks being reluctant to lend to one another. The Fed's move to reduce the discount rate helped stabilize the situation.

Outlook

- **Banks have subsequently raised lending standards and reduced the credit they are willing to extend.**
- **Defaults on subprime loans have the potential to rise as many subprime loans are scheduled to reset to higher interest rates over the course of the next year (approximately $30-35 billion per month).**
- **Increasing defaults in the future could lead to further tightening of lending standards and therefore, higher rates. Higher mortgage rates could slow consumer spending and therefore potentially stall economic growth.**

Historical Impact of Federal Reserve Rate Cuts

The Federal Reserve lowered the Fed Funds rate on September 18th from 5.25% to 4.75%. An examination of historical data shows that rate cuts by the Fed, when reversing the direction of rates, have generally been good for equities.

► **Since 1947 there have been 12 periods where U.S. interest rates have changed direction – from increasing to decreasing.**

► **Median returns for U.S. stocks after the rate cut are 7.2% for the first 6 months and 13.1% for the 12 months after the first rate cut.**

- **In four of the twelve inflection points identified, U.S. stocks experienced negative returns over the 6 months following the rate cut (median return of -7%). All four of these occurrences were either during or preceding a recession.**

- **In periods where there were rate cuts and no recession, performance has historically been very strong with a median return of 20.1% over the 6 months following the first rate cut.**

For more information, please contact any of the professionals at DiMeo Schneider & Associates L.L.C.