



FNMA/FHLMC Comments September 10, 2008

With all other options being considered, it was determined over the weekend to place the Government Sponsored Enterprises (GSE) in conservatorship. It's hard to imagine after the extended powers granted to the Government in July with respect to FNMA (Fannie Mae) and FHLMC (Freddie Mac), that the market wasn't anticipating something of this magnitude. However, the timing of the action is somewhat surprising, as the agencies have continued to finance their debt at normal rates. Foreign investors have been a huge source of liquidity and that participation has been substantially lower due to concern over the GSE's debt and capital levels. Also more recent findings that both agencies were being somewhat aggressive (although not illegal) in accounting practices, which overstated levels of capital played into the timing equation. With this information, the action of the Treasury was an attempt to provide a level of stability in the markets, reduce risk, and increase availability of mortgages to borrowers through lower rates.

For equity and preferred stock holders, the terms of the bailout are not positive. However, for bond holders, it is just the opposite. The Government has announced that they will fully back the interest and principal payments of the senior and subordinated debt of the GSE's. The debt does not become the full faith and credit of the US Government, but the government is guaranteeing that FNMA and FHLMC will be able to repay on its outstanding debt by providing needed capital. While spreads and pricing of the senior debt (which is what the majority of our clients own), have held up as anticipated and appreciated somewhat, the subordinated debt (which we own very little) has seen the most appreciation and tightening of spreads. Both types of debt have been trading as "quasi-Treasury" debt, in terms of perceived quality and it is anticipated that this will remain the case.

While this primarily directly effects FNMA and FHLMC, the Federal Housing

Finance Agency, which will oversee the GSE's, the Federal Home Loan Bank (FHLB), which falls under this umbrella as well, is profitable and unlikely to use this available resource. It has performed remarkably well over the last year due to the fact it has a different business model and capital structure than FNMA & FHLMC. Federal Farm Credit Bank (FFCB) is not included in the actions by the Treasury, is regulated by a different agency and has not been affected by the housing problems.

Although there are a lot of unanswered questions concerning the long term effects of this move, most would agree it is a positive for the financial markets in the short term. Our opinion of Government Sponsored Enterprises and their appropriateness for our clients has not changed. We feel this is a positive move and will continue to invest in these agencies due to our confidence in the underlying securities now coupled with explicit government guarantee.

Beth Swartz
Senior Vice President