

If you like conspiracy theories you're going to like this column.

Let's begin back in July when what is called the "subprime mess" really hit the news. I manage portfolios of tax-exempt bonds and for many years one of my favorite types of these has been bonds backed by mortgages and issued by state housing agencies. These mortgages are, overwhelmingly, 30-year fixed-rate loans where the purchaser has equity in the home. They are not subprime. In July, I began to see some of my portfolios declining in market value every day. After watching this for almost two weeks, I called the offices of the California, New York and South Dakota Housing Agencies. I told them who I am, what I do and that I owned positions in their bonds. Then I asked, "Are you having problems?" "In all three cases the response was the same; a surprised tone and, "No, why are you asking?". The Californian happened to have some information he had just studied, which was that their delinquency rate was higher in 2005 than it was in June, 2007. I was somewhat reassured. About a week later, with absolutely no notice anywhere in the press, the market values of these bonds began a move that within a few weeks recouped all of the loss and rose to new highs.

As this was unfolding in July, I happened to stop at the office of a friend here in San Antonio one afternoon. As we talked, some other people came into the office and said they had just heard that Thornburg Mortgage in Santa Fe, N.M. was about to fail. I have a friend who works in the investment arm of Thornburg, and I immediately called him. From that conversation and from the appearance of the chief of the mortgage company on TV that evening it became clear that Thornburg does not make subprime mortgages. In fact they do only jumbo mortgages. Within 48 hours Thornburg was out of the news.

Lest anyone think that the "subprime mess" rotated around me, let me detail a few other events: On August 21st it was announced that BNP Paribas, a large French bank was freezing three money market funds which it offers. The explanation was that some of the assets of these funds are commercial paper that is backed by US subprime mortgages. Very suddenly, the bank learned that there was no bid for this paper and therefore it could not be priced. As most people know, a money market fund always has a share value of one dollar. To accomplish this, the fund manager must frequently confirm that every security owned by the fund is worth its face value. If this is not so, then the fund's market value would fall below one dollar and that would be catastrophic for the fund. So, American mortgages almost wrecked three French money market funds.

A short time after this happened some jolting pictures came out of England. They showed depositors of Northern Rock Bank lined up outside of various bank offices seeking to withdraw their deposits. The problem causing this loss of confidence and this scene, reminiscent of U.S. banks' experiences in the 1930's, was the fact that Northern Rock had invested in U.S. securities backed, in part, by subprime mortgages. Even though the Bank of England has tried to calm customers' fears, Northern Rock is not yet out of the woods. So American mortgages have nearly wrecked an English bank.

Just last week the New York Times carried a story about Narvik, Norway. Narvik is a major port in Norway from which the country ships much of its natural resources. The

Times' story was about the fact that Narvik has suffered a huge financial loss. The city chose to invest much of its financial assets in securities, shown to it by a Norwegian investment firm, that are backed by U.S. subprime mortgages. The city can barely function. Narvik has nearly been wrecked by American mortgages.

The December 5 New York Times carried a story about multibillion dollar fund run by the State of Florida. The fund is an investment pool for local governments in the state; a place where cities, counties and school districts can earn good returns on their cash balances with little risk. The fund, unfortunately, had invested in, you guessed it, securities backed by subprime mortgages. The result was a freeze on withdrawals from November 29 at least through December 5, which affected payrolls and services.

In the December 3 New York Times, Paul Krugman had a column in the OP-ED section which he titled "Innovating Our Way to Financial Crisis." He talked about the fact that liquidity in financial markets has been drying up because of a loss of trust. This fact is still obvious from the very low interest rates on treasury bills compared to those on corporate money market instruments. Krugman's major points, with which I agree, is that what he called "financial innovation" has run amok. All over the world, from Narviks and France and England, to Florida and Thornburg Mortgage and the market for U.S. tax-exempt housing bonds there is fear and confusion. That fear and confusion stems from a series of interrelated innovations. Our housing market was soaring and the players there tried to get marginal participants into it. They did this with gimmicky mortgages that allow non-qualified buyers, basically people with insufficient income, to buy a house. The next innovation was to sell these mortgage to some party who could package them in instruments that serious investors could be convince were safe. This process has become so complex that, as noted in Paul Krugman's column, Fed Chairman Ben Bernanke required a face-to-face refresher course from hedge-fund managers in mid-August.

We have yet to see the full scope of this situation. In addition to the situations I have describe, many investment and banking firms, like Citigroup, Merrill Lynch and Bear Stearns have taken significant hits and heads have rolled. The housing market in California, Arizona and Florida has cooled considerably. And there is something that keeps coming to my mind.

One of the best books about markets I ever read was "The Day the Bubble Burst" about the stock market collapse in 1929. One of the things it described was market manipulation schemes that were common in the late 192's, and how they inflated the market. Since I read that I have been convinced three of the greatest pieces of legislative regulation are the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940. I have lived with and done business under these acts. Sometimes they were a pain but they forced us to create markets that were level playing fields and to fully and honestly inform investors about risks. The events I have described here clearly indicate that markets and technology have moved beyond the regulation structure of those acts. The result of that move is obviously dire and its scope is yet to be seen. It is imperative that we, government, businesses, private citizens, take immediate

steps to update regulation and operation of our financial markets. Investors must understand the risk they are taking. Failure to do this will not be pretty.