Rescue Offers a Short-Term Salve for Stocks; Fannie and Freddie Likely to Plunge, Searing Investors

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ProQuest document link

Full text: The government's plan to take over Fannie Mae and Freddie Mac may help the housing market and boost the value of the firms' bonds, but it is a body blow to stockholders that include some of the country's best-known mutual funds and biggest banks.

Under the plan, the government could wipe out most of the value of the common shares by buying nearly 80% of both companies "at a nominal price." That would leave common stockholders with the remaining 20%, or one-fifth of what they owned Friday.

Owners of the companies' $36 billion in preferred shares also will fare badly. They already have seen the value of these once-safe securities fall by half, and some argue that the shares are worthless now that the dividends have been halted and because they will absorb any losses before the U.S. government is hit with them.

The ultimate value of both securities depends on how well Fannie and Freddie perform and how the government rescue effort plays out over the next several years.

For stock investors, the takeover makes a bad situation worse. While they were once among the biggest companies in the stock market, Fannie and Freddie saw their shares' worth reach $7.5 billion and $3.3 billion, respectively, Friday. Freddie's shares have fallen 92% in the past 12 months, while Fannie's are down 90%. For those who bet against the shares, it was a windfall and a vindication.

Fannie Mae closed Friday at $7.04 and Freddie at $5.10, and both fell sharply in after-hours trading on word that a takeover was imminent. They are expected to plummet when the market opens on Monday.

"Based on this announcement, one can reasonably conclude that things must be materially worse at Fannie and Freddie than what the companies and the government had acknowledged only several weeks ago," said William Ackman of Pershing Square Capital Management, who has been shorting Fannie and Freddie stock since early this year.

When it comes to the holders of the bonds backed by home mortgages that Fannie and Freddie issued, the step makes those obligations "money good," said Bill Gross at bond fund manager Pimco.

"The Treasury doesn't want to guarantee a trillion in assets . . . but it's a big step. I think not only the Pimcos of the world, but also the sovereign-wealth funds and central banks will gain confidence that there is absolutely no possibility of default," he said.

That means those bonds are likely to rally, narrowing the gap, or "spread," between yields on these securities and Treasury bonds. That, in turn, should help lower interest rates on new home loans, making them more affordable for borrowers. Fannie and Freddie were supposed to fulfill this role by purchasing more securities, but their capital positions limited their ability to significantly expand their mortgage investment portfolios.

One big unknown is whether investors will grow more worried about the creditworthiness of the U.S. government given how much additional debt it has taken on. If that occurs, interest rates of Treasurys could rise, which could slow an economic recovery.

The carnage is widespread. The development is another blow to Legg Mason's Bill Miller, whose flagship Legg Mason Value Trust mutual fund is down 31% this year. In early August, Mr. Miller's group reported that it had raised its stake in Freddie Mac to 79 million shares from about 50 million earlier this year.

That move made investors in Legg's portfolio the largest shareholders of the company. In a shareholder letter, Mr. Miller dismissed the selloff of Fannie and Freddie as part of a "frenzy" that took financials to their lows in mid-July. Mr. Miller didn't respond to a request for comment.

A big miscalculation on the part of stock investors was to focus on whether the two agencies were technically

insolvent and on their business prospects but miss the risks that a weakened Fannie and Freddie posed to the battered U.S. housing market.

Investment firm Dodge &Cox, for example, justified its investment in Fannie by saying the company was gaining market share. The firm, which owns roughly 119 million shares of Fannie, bought the bulk of its stake in the first quarter, when the stock was trading between $18 and $40 a share.

"We are currently studying the implications of the unprecedented action . . . and are reviewing our options," a Dodge spokesman said Sunday.

Pzena Investment Management, which owned 21 million shares of Fannie Mae and at one point counted the stock as among its funds' biggest holdings, defended the two agencies in July in a public three-page letter titled "The Case for Fannie and Freddie" in which the company's managers wrote that both had sufficient reserves and capital and "significant revenue generation capability."

It is unclear what will happen to Fannie's and Freddie's publicly traded stock. Top officials of the New York Stock Exchange have been in discussions with government officials and other parties about the situation, according to a person familiar with the matter.

If the shares fall below $1, the NYSE may be forced to impose a so- called operational trading halt, which means Fannie and Freddie shares would stop trading on the exchange floor and move to electronic platforms such as NYSE Arca. In the longer run, the companies could be delisted if they no longer meet NYSE criteria.

Also feeling pain from the buyout will be many of the nation's banks, which own preferred shares in the government-sponsored entities that were once worth billions of dollars. In recent weeks, a slew of banks have disclosed their holdings to investors and, in some cases, written off the value due to the steep declines in Fannie's and Freddie's stock prices.

That means more bad news for the banking industry, which is reeling from rising defaults in everything from mortgages to credit cards, as well as poor returns on other mortgage-related investments. The government takeover plan appeared to take this into account, saying only a "limited number of smaller institutions" have holdings of common and preferred shares that are significant as compared to their capital.

But the bigger impact on banks might be their ability to attract new investors. "Preferred shares have been a primary tool for banks and dealers to raise capital, and these developments could impound the asset class" and make it harder for others to sell similar securities, says John Miller, chief investment officer of Nuveen Asset Management, which has a preferred-stock fund.

The Treasury sought to assuage concerns Sunday, saying that preferred stock of Fannie and Freddie "are not a good proxy for financial institution preferred stock more broadly."

J.P. Morgan Chase &Co. is among the banks that will likely suffer losses due to its exposure. The bank recently disclosed in a regulatory filing that its $1.2 billion investment in preferred shares of Fannie and Freddie had lost about $600 million in value.

A J.P. Morgan spokesman declined to comment on the government takeover of the two entities.

In a report issued last month, debt-research firm CreditSights cited M&T Bank Corp. and Sovereign Bancorp Inc. as being among the most exposed to Fannie and Freddie preferred stock. The CreditSights report estimates that a total write-off of Sovereign's holdings in Fannie and Freddie could wipe out as much as four quarters of earnings.

In response to that report, Sovereign said that it took into account potential declines in its investments when it raised capital earlier this year.

One concern among investors is how the takeover will play out in the credit-default-swap market, in which traders buy and sell derivative contracts that act like insurance against debt defaults. Swaps tied to Fannie and Freddie debt are likely to fall in value because government backing sharply reduces their default risk.

Some analysts say the takeover might trigger payouts under the contracts because of how their terms have been worded -- in many contracts, an appointment of a conservator can be considered a bankruptcy.

Still, investors who bought default protection are unlikely to reap a windfall because Fannie and Freddie bonds will trade close to their full value, said Richard Hofmann, an analyst at CreditSights. In most cases, when a company defaults on its debt or goes bankrupt, its bonds are usually worth a fraction of their full value, and swap payouts would compensate for the difference.

Liz Rappaport and Diya Gullapalli contributed to this article.

(See related article: "Abreast of the Market: Though Market Could Rally Today, Problems Remain" -- WSJ September 8, 2008)

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Subject: Government sponsored enterprises;

Company / organization: Name: Fannie Mae; NAICS: 522294; Name: Freddie Mac; NAICS: 522294;

Classification: 3400: Investment analysis & personal finance; 9550: Public sector; 9190: United States

Publication title: Wall Street Journal, Eastern edition

Pages: C.1

Publication year: 2008

Publication date: Sep 8, 2008

Year: 2008

Publisher: Dow Jones & Company Inc

Place of publication: New York, N.Y.

Country of publication: United States

Publication subject: Business And Economics--Banking And Finance

ISSN: 00999660

Source type: Newspapers

Language of publication: English

Document type: News

ProQuest document ID: 399045850

Document URL: http://search.proquest.com/docview/399045850?accountid=17203

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Last updated: 2010-06-26

Database: ProQuest Central

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