The Muhlenkamp Memorandum

Recession and the decline in house prices in many parts of the country are now rudely awakening the American public. People who two years ago fully expected to continue trading up are now prepaying their mortgage. If there wasn't nearly a decade of financial pressure (see chart) at work here, we could dismiss this trend as an emotional shift, subject to short-term reversal. But with this background, we must view it as a delayed realization, which will last at least as long as fundamental pressures remain. In a recent month, 20% of those refinancing their mortgage went to 15 to 20 year fixed rate contracts, which says to us that homeowners are making long-term commitments to "prepay their mortgage" (relative to the standard 30 year contract) in ways not easily reversed. We therefore conclude that the American public is reversing its 25 year mind set. Instead of "trade up on the equity" the new rallying cry of homeowners is "prepay the mortgage." Please re-read this paragraph three times; it's that important!

But the second part of the new reality has not yet sunk in. Despite a ten year decline in interest rates, the mortgage borrowing public, fearing that rates will "go back up", is still insisting on fixed-rate mortgages. Any fixed rate below 10% is being "locked up" in the belief that it's a temporarily low rate. Meanwhile, the borrower's retired parents are *hoping* that rates will go back up. Banks and savings and loans are telling us that despite the big drop in short-term CD rates (to the current 5% level) many retirees are shortening maturities to 30 or 90 days until rates "go back up." Due to the broad attitudinal changes which we've outlined above, we believe these people will be disappointed.

Contrary to popular opinion, bankers and other financial intermediaries don't care about the level of interest rates. They work on a 2 or 3 percent spread. The savers of the world (our parents) will receive 2 or 3 percent less on their deposits than we, the borrowers, are willing to pay. As long as borrowers were willing to pay high rates (because they expected to make money on the asset) they were not active in negotiating lower rates. In the last year, this expectation has reversed. Borrowers are no longer willing to pay 10 or 11 percent, so lenders (savers) will no longer receive 8 percent.

But that doesn't stop them from looking for it! Some walk into brokerage offices and buy anything that promises 8%. Today the demand for mortgage participation is so great that yields have been driven down to Treasury levels, even though the mortgages are subject to prepayment at the option of the borrower. People who buy Fannie Mae or Ginnie Mae certificates hoping for an 8% long term return are going to be disappointed because, as we noted above, mortgage prepayments are increasing. These same people will be back in the marketplace two or three years from now looking for 8% again, and it will not be available. Other people make basically the same mistake by buying current-coupon corporate and municipal bonds or preferreds. As interest rates fall these instruments will be called or redeemed at the earliest profitable opportunity. The October 11, 1991 "Wall Street Journal" headline reported that the US Treasury is calling some bonds for early retirement, a move, it said "will shock many investors". Folks, all borrowers call or redeem their paper for the same reason you or I refinance our mortgage: lower interest costs. The ability to recognize and (more importantly) make your portfolio reflect this fact comes from asking simple questions: Who is on the other side of the piece of paper? What will he or she do? It takes some thought and effort sometimes to get the answer, but it's worth it.

A final comment: we know what the baby boomers are doing; they are paying down their mortgages. We don't know what the retirees are going to do. In our "Time Bomb" essay of 1989 we warned that "incomes" were likely to drop from 8% to 5% or lower. The facts have now verified this, but the realization has not yet sunk in for most retirees. Most still live by the maxim: spend the income -don't touch the principal. In the inflationary cycle of the past twenty years, this maxim has become a trap. Now becoming aware of the trap they are in, retirees actions so far have merely been stopgap, searching for 8% short-term fixed income returns in a 5% world, with little attention paid to callability. Retirees are faced with the choice of investing in long-term assets, which carry price risk, or accepting a 40 percent cut (maybe more soon) in their "incomes."

As is often the case in investing, those who saw the pitfalls early have more and better options available for avoiding them. Over the last several years, we've helped our clients spot some of the hazards on the road to financial security. Today the options are diminishing fast; maybe we can help you as well.