Comment: It's time for a bit of Schumpterian "creative destruction"

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*With all the talk of hedge funds closing down, we are pleased to bring you a guest contribution today from Ronald Solberg, one of the founders of a new hedge fund firm **Armored Wolf, LLC**. Solberg is also the author and co-author of multiple titles on risk analysis, portfolio management and emerging markets including Sovereign Rescheduling: Risk and Portfolio Management, and Efficient Allocation of an Emerging-Market Bond Portfolio.*

Guest contribution from: Dr. Ronald Solberg, Managing Director, Armored Wolf, LLC

Earlier this week, the proposed bailout package did not pass the US House of Representatives. But whom exactly are we proposing to bailout?

Shall we reward the homeowner who overstated their income to obtain a mortgage they could not afford? Shall we aid the mortgage broker who pushed a loan on an unsuspecting, over reaching homebuyer? Shall we give mortgage relief to the speculator that bought 10 homes with no money down and now cannot fund their ill conceived venture? Or how about the bankers who, when allowed by the SEC, raised their leverage from 12x to 30x, meaning that only a 3% loss on their portfolio would wipe out their equity? Shall we extend assistance to the portfolio managers who bought lower tranches of ABS and MBS without doing their homework on historic default rates and adjusting them for fat-tail events?

Should the unsuspecting taxpayer be saddled with the cost of this bailout? Despite loud assurances, no one can guarantee, in all candor, that the taxpayer will ultimately make money from sponsoring this bailout. Furthermore, would such a bailout be fair to the household that chose to live within its means by funding their mortgage with a 20% down payment and a fixed rate? Or how about the person that recognized the insanity of the housing price bubble and chose to rent rather than buy a house at an inflated price which was driven by silly mortgages, absurdly low interest rates and earnest buyers stretching beyond their means? Lastly, shall we punish the investor who bought CDS to protect against the default of Wachovia only to find that the bank disappears without a formal Chapter 11?

There is a lot of bad advice being rolled out in the chaos of the current financial meltdown. Do we need to stabilize home prices, try to raise them, or allow them to fall further? Many observers are calling for stabilizing home prices or even attempting to raise them back to their peak levels. Let's examine whether this is wise.

One of the root problems of the current crisis is that homeowners had taken on too much debt to overreach for a house they could not afford. Many homebuyers over the past seven years, had they financed their purchase with a down payment and a mortgage they could afford, would have been in a smaller house or would have continued to rent. But, alas, the allure of stainless steel appliances and granite countertops was irresistible.

Assuming we want to reward good behavior and punish bad behavior, a bailout for the overreaching homebuyer is bad policy. Home prices in the US need to become more affordable, which they have started due to the 16.4% price decline over the past year, according to the CaseShiller Home Price Index. In the hottest home markets in the US, prices rose nearly 4x in the decade prior to the peak in mid 2006. Of course, in other regional markets, price appreciation was more modest. However, the point remains that it was unsustainably low interest rates combined with ill-conceived mortgage products and no skin in the game (down payment) that drove much of the home price appreciation. If government policy tries to stabilize home prices at the current inflated levels, they are dooming the American consumer to continue to struggle to afford moving up the home ladder.

Over the past decade, nominal wage growth has not kept pace with inflation, so real wages have fallen. Households

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responded by saving a smaller and smaller portion of their income to maintain their lifestyle until their saving rate actually became negative. Once that was tapped out they relied on home equity loans to fund consumption. It is ironic, if not tragic, that despite such strong home price appreciation in the decade to mid 2006, the amount of home equity enjoyed by the average American household has actually fallen.

Relying on mortgage "innovation" was the last gasp for the increasingly beleaguered American consumer. Yet it was the lack of a down payment at purchase along with other mortgage features such as negative amortization, interest only loans, amongst other ill-conceived enhancements, which fuelled the blow off top in home prices and dug the financial graves for millions of households. Who it to blame for this?

Will people be held accountable for their own decisions? Many homeowners willingly entered into a mortgage contract without a gun to their head, knowing full well they could not afford the higher payments that the contractual reset of the teaser rates made inevitable. Were other homebuyers subject to deception by mortgage brokers? Were appraisers subject to groupthink or, even worse, collaborating with real estate agents? Was monetary policy overly easy in hindsight and too transparently telegraphed with its methodical 25bp hikes? Did the banks and investment banks that incentivized the mortgage brokers realize they were creating a principal-agent problem, increasing the likelihood of bad mortgages being underwritten? Did the investment banks obfuscate the underlying loan quality of mortgage-backed securities by making products too complicated? Did the revenue-hungry rating agencies have the expertise or will to appropriately opine on the quality of CDOs, CLOs and other new complex products? Did institutional investors ignore proper risk analysis because they were too hungry for performance because yields had been driven down by an extended period of low interest rates and flush global liquidity?

It seems we have had a perfect storm. As Chuck Prince, Citigroup's former Chief Executive said in July 2007, "As long as the music is playing, you've got to get up and dance", adding, "We're still dancing". It was a perfect harbinger of the onset of the subprime crisis that has now morphed into a full-blown financial panic that has changed the profile of the US banking system and capital markets forever.

Let's not make bad laws in haste and further compound our problems. Let home prices fall to a level where they are once again affordable for the average American that would prudently finance the purchase with a substantial down payment and an affordable mortgage. Keeping home prices artificially high will only doom future generations to an excessive debt load or alternatively, create a political consensus for a populist inflationary wage surge that would create the appearance of affordability at the expense of declining US competitiveness or a further erosion in the purchasing power of the US dollar. It's time for a bit of Schumpterian "creative destruction" to admonish the nascent American values that abhor saving, scoffed at the concept of paying off a mortgage, and used their home equity like an ATM machine. It is time for Americans to be accountable for past mistakes, suffer the economic consequences, consolidate, and re-establish sound finances on Main Street, Wall Street and in Washington, DC.

- Ronald Solberg, September 30, 2008

The opinions expressed in this guest posting are those of the author and not necessarily those of AllAboutAlpha.com.

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1. Thomas **October 7th, 2008 2:48 pm** :

   So why do I feel like a dumbass for saving my money, buying a house with 20% down and 30-yr fixed at a low rate and yet I will still lose in all of this? As much as people like to characterize the real estate market by what happened at the margins, the reality is that the vast majority of the market is composed of rational actors who followed prudent practices but will still be punished mightily. As the generation behind the baby boom generation, it feels like everytime it is our turn to partake in the American dream it has been sucked up and destroyed by those before us. Whether it's in owning a home or getting ready to ascend to executive management, the generation before me is destroying hope in the American dream with surprising efficiency. And it sucks.

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