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Stamper Capital & Investments, Inc.

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DerivActiv

MuniMarket Pulse

Interviewee: B Clark Stamper, Chief Investment Officer and President of
Stamper Capital & Investments, Inc.

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By Johan Rosenberg | 04-08-2008

Interviewer: Johan Rosenberg, CEO of DerivActiv, LLC, and
President of Sound Capital Management, Inc.

Duration: 12 minutes, 34 seconds

DerivActiv is an independent swap and derivative management firm. With personal service and proprietary software, we deliver daily valuations of interest rate swaps and other financial derivatives, cash flow verification, and collateral management through our secure website.

Johan - B Clark Stamper, Chief Investment Officer and President of Stamper Capital describes why history repeats itself with failing hedge ratios for muni fund managers. Stamper also describes declining new issuance and predicts widening credit spreads. You've had a pretty long fixed income career since 1984. You've traded treasuries, mortgage backs. You've seen different portfolios blow up from time to time. I think that's a pretty unique experience.

Clark - I helped restructure a lot of portfolios starting in '84 and all the way through '91 when I was done restructuring this portfolio plus the junk bond portfolio.

Johan - There is one quote here that I'm going to read. You saw risk controlled arbitrage blow up and bankrupt many savings and loans in 1987. The most knowledgeable and well known rocket scientist for major Wall Street firms explained that their hedge ratios didn't work as planned because prepayments of mortgages came in faster than any time in history.

Clark - That's right.

Johan - That's resonating for me on what's going on right now for hedge funds.

Clark - It's the opposite of what happened in '94 and it's very similar to Long Term Capital in '98 and it's very similar to what's going on right now. Absolutely.

Johan - A lot of muni hedge funds have hedged out with treasuries or LIBOR swaps and expected ratios to be XYZ and they're not, they're quite opposite.

Clark - Mostly those hedge ratios work within a certain band and when you get out of the band then the whole thing falls apart. That's what happened in almost every case. In '94 if you remember it was derivatives and instead of rates coming down and prepayments accelerating rates went up and prepayments slowed down and you had extension. So they had 30 day bonds, or what they thought were 30 day bonds, became 30 year bonds and then instead of being par they went down into the 80's. That actually made a lot of money market funds break the bucks.

Johan - What the market has done here has caused to munis to trade at 105 to 115-percent of treasuries just because of lack of liquidity in the muni space. There is one more interesting thing that I heard here which I think is fascinating. Some firms acting as prime broker overnight added 1.5% to the yield on the valuation of the munis and that forced a bunch of margin calls and frenetic selling.

Clark - Actually you had the first illiquidity event in March of '07 was a commercial paper and then in the middle of the year in June and July you had the muni insurers start coming under question and their stock prices are starting to drop. And that was the first time you had treasuries rally and munis trade off a little bit because the previous six years you had more and more hedge funds coming in and they were buying munis and shorting treasuries. Because they were buying munis the muni yield was going down and getting tighter and tighter and tighter and here was the first time where you saw a little shutter of the reverse of that. In October, November, you saw a little larger shutter and then you had the auction rate securities auction fails in January which upset the market a little bit and became more of a liquidity issue and it was such that it pushed prices of munis down even while treasuries were rallying and two giant hedge funds basically had margin calls and had to liquidate and that's why you had a terrible March.

Johan - That was sort of like the February timeframe. What I hear is they added this 1.5% yield premium to the valuation.

Clark - Those were the steps of how we got there. Again, it was the hedge ratio worked and worked and worked and worked for six years and then all of a sudden it didn't work.

Johan - I'm just going to extract from you quote here that you do things slightly differently, or that you have a wider band or you don't have as much risk tolerance.

Clark - No, we focus on the upside potential and downside protection of each investment on its own with respect to credit quality which would be like a mortgage or not having a mortgage or something like that, where it is in the capital structure. Just like underwriting a junk bond. Also with respect to security characteristics which would be the call and the sinker and the coupon and the dollar price and the yields versus the yield curve. Sometimes we give up downside protection and take on upside potential, however this last cycle of course we gave up upside potential and picked up a lot of downside

protection which is why we performed so well, especially in February 2008.

Johan - What's going to happen here with secondary market volume as a result of more distress or not and where are muni yields heading in the rest of '08 in your opinion?

Clark - All of the volume is kind of slowed down because a lot of bonds that normally would be called they can't really reissue insured because the insurance isn't respected enough so they are not getting enough bang for the buck as far as bringing the yield down to refinance. The amount of new issuance has plummeted a huge amount and the secondary is pretty weak. The bid is just weak, all except for the higher quality issues. However we've seen somewhat of a rebound in the bid since the Bear Stearns bailout. Looking forward I think the easy call is lower quality yields probably go up. The highest quality yield, escrow type bonds, AAA underlying on their own, no insurance, that's a tougher question. It could be going down. We could be more in an environment like Japan where they have very low and lowering interest rates for a long period of time.

Johan - The absolute rate curve is going down but credit spreads are widening so - depending on - the people who don't need to borrow are going to have better rates.

Clark - Exactly. The people who don't need the advantage will get the advantage. The people who need the money will have to really pay for it.

Johan - I just want to come back to this buying bonds with insurance or not. I was looking at a couple of healthcare bonds that priced on the 31st. One was a \$28 million deal, A- underlying, sold in Wisconsin and on the same day, 31st, we had another deal that was A2/A+ with Ambac insurance through the Illinois Finance Authority. Both healthcare, both in the A category, but it was anywhere from 25-40 basis points of a yield differential. I looked at that and I said, 'what were the differences between these two bonds?' One is a little bit of size, one was A- versus A2/A+ and then the Ambac insurance. OK, maybe Ambac insurance really does deliver value or the credit cliff between an A2/A+ and an A- is so steep that that's why this other bond priced so poorly.

Clark - That was probably more the reason.

Johan - You think that just within the A category the credit cliff is that steep?

Clark - I think that once you get down to A and lower the market is all over the map. I have some private accounts I've been liquidating, just not even worrying about the insurance but looking at the underlying ratings. If the underlying rating is AA or A+, no problem, but once it gets to A on down, the bid is really spotty.

Johan - You wouldn't attribute any of that lower coupon the Ambac insured to actually the Ambac insurance . . .

Clark - The fortunes and the viewpoint of people on Ambac have been going back and forth but the stock is still way down. I would say the market in general still is not giving

them a huge amount of value.

Johan - Would you say the same thing for MBIA bonds right now?

Clark - Probably the same thing, yes. I've been liquidating a lot of bonds that are MBIA or Ambac and believe me the differential is what the underlying rating is or what the underlying credit is. It's not the insurance.

Johan - When you are looking for value in bonds, I looked at your profile here it looks like a big percentage of your bonds are AAA rated and when you look for value in bonds, are you looking at buying bonds in different parts of the curve and looking at between 10 and 15 right now or long or short, or do you just look at the whole bond and buy a little bit across the whole curve?

Clark - We look at each individual bond on its own with respect to credit quality. Upside potential and downside protection with respect to credit quality characteristics and also with respect to the security characteristics. Right now, like I said, we are not really giving any insurance except for FSA much credit so are really focusing on the underlying rating and even more importantly the underlying security. Is it a first mortgage, is it a net water revenue bond, is it a GO. Is it an unsecured senior debt obligation of a hospital, that would be something that we are not too hot on. Then we are looking at it versus the interest rate environment, the yield curve. The curve has steepened a lot so if we were going to buy longer bonds, we'd buy longer duration bonds because they could rally. However, like I said, I'm not too constructive especially on lower quality bonds as far as there interest rate direction, so I'd only buy the highest quality. What we are buying, we buy a lot of cushion bonds, that would be big coupon bonds, trading to a short call. If they were non-callable they might trade at \$120 for an example, but they are called at 102 so the trade at 103, so we have 17 points of downside protection. In that example, so the bond market, the muni market could drop about 17 points before that bond would drop, in the meantime we are getting a bigger coupon. However, once that bond drops, then it loses its downside protection. It doesn't have much upside potential because it could be called away so we would sell that bond and maybe buy discount market performer down in the low 80's that had a lot of room to run. We are looking at it versus the entire curve, versus the entire call schedule and the sinker and also with respect to credit quality.

Johan - Are you buying bonds from across the US or just mainly California in-state bonds.

Clark - We're national. We have a few states that are over 10%. California is one. However, most of those, at least probably about half of those bonds are escrowed. We really like escrowed bonds because they have the highest credit quality. So we are not really state specific right now. Sometimes when certain states are trading in particular very cheap we will be buying those, but that is not true right now. They are all about even. It really has to do with the individual bonds more than going after any particular category.

Johan - Are you following the Kentucky versus Davis case in the Supreme Court.

Clark - We followed that and it was funny someone asked me a question about that last week and I kind of had forgotten all about it. It's totally fallen out of the press because I think of all the stuff having to do with auction rate preferred, the auction rate securities and the insurance problems. My view on that is if they do make these bonds not be special for each state that they'll get the congress to create a new law which basically makes it how it is already right no. I don't see how they would let that go away.

Johan - It's just too messy.

Clark - I think it would be very painful for certain states, like California, the high tax states.

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