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Caveat Emptor: Why You Shouldn't Jump (Back) in on Fannie and Freddie

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Quick… what is the value of a non-cumulative perpetual preferred stock that does not pay a dividend? The answer is zero. Nil. Zilch. Nada.

There is, of course, one exception - the dollar bill (of any denomination). Despite not paying a dividend, U.S. currency derives value from the explicit support of the U.S. government.

Otherwise, finance theory would suggest that such a financial instrument would have no value. So, why do the preferred shares of Fannie Mae and Freddie Mac hold any economic value today, since unlike U.S currency, these instruments do not enjoy a government guarantee?

This is an important question for investors to ponder – particularly those investors previously burned holding Fannie and Freddie preferred stock who are contemplating a shot at redemption.

The big losers in Fannie and Freddie preferred stocks during the credit crisis were small community banks and retirees seeking a steady stream of dividend income – as these investors comprised the majority immediately prior to the government conservatorship in 2008.

Who owns the majority of shares today? Hedge funds and investment managers that purchased the shares from the original investors at cents on the dollar, and that have driven up the value of these shares to 40 to 50 cents on the dollar through purchase transactions well in excess of the market liquidity of these shares.

These levels simply cannot be supported by any reasonable forecast of fundamentals - absent the ability to accurately predict the outcome of lawsuits and resolutions to a number of regulatory and legal matters that are unlikely in the near to medium term.

Thus, the strategy of these investment managers appears to be to create the appearance of significant value through purchases that materially drive up the prices of both the preferred and common shares of these GSEs and to initiate lawsuits with uncertain outcomes. If successful, this would allow them to exit the shares at significant gains – likely through sales to the investors who previously sold the shares to these hedge funds and investment managers at significant losses.

In September 2008 I wrote an Issue Brief about the conservatorship, an excerpt of which reads as follows: *"Finally, the legality of this action remains hazy. The extent to which shareholder rights have been violated is currently unclear, but this topic is likely to be a major issue going forward."*

So, I too questioned the legality of the actions taken by the Treasury. However, even positive outcomes for shareholder claims in these lawsuits will not necessary reward the current shareholders. Instead, it is quite possible that any monetary damages awarded will be to those who were actually harmed – the owners of record at the close of business on the day before the conservatorship – not those who purchased the shares after the conservatorship at cents on the dollar. If this turns out to be the outcome, then in this case, these aggressive asset managers have actually performed a valuable service to right a wrong!

Let's return to the question of value of the GSEs and discuss how it would be possible to obtain an objective valuation of Fannie and Freddie today. Since these entities have turned profitable and the explicit capital support provided by the taxpayer has been repaid ($187.4 billion), an argument is being made by shareholders that the sweep of all profits of Fannie and Freddie to the U.S. Treasury is unfair treatment of the private shareholders.

While it may be true that the explicit capital support by the taxpayer to back these entities has been repaid, what remains is a fairly significant amount of implicit capital support. Yet, this implicit capital support does not appear in any financial statement and remains un-quantified. As a taxpayer, I believe this support must be quantified so that taxpayers can be paid appropriate economic compensation.

Although it would likely take a team of government economists months, if not years, to derive the magic formula to value the implicit support provided to the GSEs, a simple experiment could do the trick in little time. Let's imagine the economic consequences of a Treasury Department announcement that it would no longer provide capital support, liquidity support or financial backstops of any kind to the GSEs.

It would be up to the private shareholders to shoulder the entire burden of financial support - if they expect to enjoy the economic rewards of owning these entities. Additionally, to prevent a panic in the debt markets that would result from such an announcement, the Treasury Department would offer existing investors in GSE debentures and agency mortgage-backed securities the ability to purchase an explicit guarantee on these obligations from the Treasury for an insurance fee.

What would be the resulting consequences of such an announcement? Absent a material capital contribution by private shareholders, the credit ratings of the GSEs would be instantly downgraded - likely to junk - and the credit spreads on its debentures would widen hundreds of basis points. Spreads would also widen on all mortgage-backed securities guaranteed by the GSEs.

Needless to say, the traded market value of the preferred and common shares would be wiped out. If the total aggregate decline in value of the debentures, agency mortgages and the preferred and common stock after such an announcement could be totaled, it would serve as a reasonable estimate of the amount of implicit taxpayer capital support these entities currently enjoy.

Accordingly, if the private shareholders decide they do not want taxpayers to withdraw their implicit support, then it is necessary to provide a fair and equitable economic return on this amount of now quantified economic capital. The private shareholders would enjoy the remaining profits in excess of the amount needed to compensate taxpayers for their implicit support.

Under this construct, all parties are treated equitably. Conversely, to have private shareholders claim that they are being treated unfairly as the GSEs return to profitability because the explicit capital of the government has been repaid is disingenuous as it ignores the major source of implicit capital support by the taxpayer.

Of course, private shareholders may disagree with my solution. The good news is that the government could easily resolve the issue by making the above thought experiment a reality!

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