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Prior to joining Merrill Lynch, Bob was Director of Charitable Services for Van Deventer & Hoch, Investment Counsel. While there, he assisted charitable organizations as a portfolio manager and consultant on the investment aspects of endowments and planned gifts. He also spent more than 10 years in private practice as a business and securities law attorney.

Mr. Fry earned a Bachelor of Arts degree from the University of Southern California and the degree of Juris Doctor from the University of California at Los Angeles. He is involved in a number of community organizations including the Christian Management Association where he was a board member for six years.

The beginning of wisdom

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THOUGH WE LIVE in an age of electronics, I still prefer reading a book to reading articles off my computer screen. For many of the same reasons, I like working with hand tools. While I readily admit that power tools and computers have their place, I enjoy the quaint reliability and simplicity of the older instruments.

There is also a type of safety in these less complicated tools. I know several guys who have lost fingers using table-saws; I've yet to meet anyone who has cut off a digit with a hand-saw. The true beauty of the older instruments is that they are simple to understand and safe to use. When I pick up a hand-saw, I know deeply and profoundly what to expect and my ability to cut things is limited by my strength and endurance. In a very real sense, the tool matches my true abilities.

A good first step toward acquiring investment wisdom is avoiding tools that are more complicated than we can understand or are more powerful than we can control.

At the very moment that you are reading this article, some of the world's largest banks and financial institutions are losing billions of dollars (that's billions with a "B") because they invested in instruments that were too powerful for them to control and too complicated for them to understand. These structures - known by names like Collateralized Mortgage Obligations ("CMOs"), Collateralized Debt Obligations ("CDOs") and Credit Default Swaps ("CDS") - all derive their values from combinations of mortgages or other debts.

In the olden days, before roughly 1983, banks could only make loans with funds that they had on deposit. Their ability to grow their business was thus limited by their ability to attract funds from depositors. These were hand-saw loans, if you will, limited by the strength of the financial institution.

But in the early '80s, Wall Street investment bankers became power tool salesmen by designing the structures just described and selling them to investors for a fee. The bankers thought that they had died and gone to heaven. They could now make loans to their heart's content, charge origination fees, sell the loans into securitization vehicles, get their money back and then do it all over again. The growth of their business was no longer limited by their own financial strength but only by their ability to sell. The CMOs and CDOs became the table-saws of the financial tool shop.

Wall Street was also delighted because they had a whole new source of very substantial fees in the packaging and selling of these securities. On the theory that, "if a little power is great, wouldn't a lot of power be even better?" Wall Street quickly added complexity and leverage to the mix. Complexity came from cut-

ting the offerings into "tranches," which is just a French word meaning slice. By giving each tranche different rights, some tranches could be deemed safer than others. Incredibly, the "safest" tranches, those with the first right to income from the underlying loans, were soon granted AAA ratings, even though the underlying assets were still very, very risky. Obviously, the AAA paper was easier for Wall Street to sell than more lowly rated paper.

Leverage grew just as quickly as hedge funds, the banks themselves and a wide range of financial intermediaries began borrowing to invest in these new-fangled securities. The details of the financing structures are too mind-boggling to describe, but suffice it to say that there are now entities such as "Synthetic Collateralized Debt Obligations" that have borrowed money solely to purchase assets in other CMOs and CDOs. This is roughly equivalent to using the engines off a 747 to run our table-saw.

The essence of the credit crisis that is growing out of defaults in sub-prime mortgages is that those loans, once made, were packaged by Wall Street into the very complicated and powerful financial table-saws just described. When things go well, these financial table-saws cut straight lines directly to huge profits. But when things go badly, these same tools start lopping off financial digits, sometimes nine at a time.

To change metaphors for a moment, the entire industry is something akin to a pyramid scheme. Only it's an upside-down pyramid. Massive investments are resting on the point of adjustable rate mortgages that are resting in turn on the backs of the most stretched homeowners in America. As those homeowners begin to default on their loans, leverage and complexity topple the pyramid.

The leverage that enabled the growth of the mortgage backed securities industry now begins to amplify the losses. The complexity of these instruments, some of which has only become evident in the past few weeks, includes the fact that none of these securities are publicly traded. Consequently, no one has any idea what they are really worth. The banks have one arm caught in a financial table-saw with controls that are so complicated they literally don't know how to turn it off. While the American economy is fundamentally sound and will absolutely survive this crisis, some of our financial institutions may lose a limb.

What is the point of all of this for ordinary people who are trying to supervise the investment of their own funds? Just this: "The beginning of wisdom is the fear of the Lord." And that fear, which implies awe, reverence and humility, has a place in the managing of our assets. It's ok to avoid investing in things we do not understand, just because we don't understand them. It's ok, in fact, to be the only one you know who's not using a table-saw, just because the thing scares you. The hand-saw of humility is a wonderful investment management tool.

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