

Chapin Hill Advisors, Inc. Market Comment
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Will the Sub-prime fallout become the prick that burst the bubble?

Back in the dot-com heyday, we heard the phrase “irrational exuberance”, especially as it pertained to the internet hot-dot plays. Optimists insisted that any fallout from a collapse in this sector would be insignificant as the entire universe of internet stocks comprised just 6% of the total stock market cap.

Over the next three years, that view proved to be dead wrong. The bleed in the dot-com stocks led to a 49% plunge in the S&P 500. Other markets followed and there was no place to hide in the equity markets for three, very long years.

This week’s Barrons’ quoted Stephen Roach, Morgan Stanley’s chief economist, comparing today’s housing bubble to its dot-com predecessor. The optimists are telling us once again that this sub-prime fallout will be contained as it comprises a small sector of the overall mortgage market. The sub-prime market accounts for 20% of our current mortgage obligations, up from less than 10% several years ago. The sound-byte from Mr. Roach that stood out for me was “*Sub-prime is today’s dot-com – the pin that pricks a much larger bubble*”.

This past week brought the virtual collapse of New Century. Now de-listed and trading for just a few dollars, this was a \$60 stock in the beginning of the year. A number of states have issued cease-and-desist orders. Deutsche Bank asked New Century to quickly buy back \$900 million of its loans. They have been hit with claims from a number of the financial institutions which funded their mortgages. The probability of these various creditors being made whole looks slim.

Accredited Home Lending is following in their footsteps although they were able to sell off portions of their portfolio at a discount last week. The stock dropped another 18% in trading on Monday now trading in the single digits – down from its high of \$60 this past May.

The fear in the marketplace is that the defaults in the sub-prime sector will lead to a meltdown in the market for the collateralized debt obligations. There is an entire “flight to quality” mentality taking over which means pricing on inventory of all types of low quality fixed income is likely to be affected. These CDO’s are often “black boxes” – no one is really sure what is in them as they are sliced and diced by Wall Street wunderkinds. If buyers start to shy away from CDO’s this means less credit for all types of things, including private equity.

The carry-trade is another concern. In its simplest version, this is where institutions borrow from a low yielding currency (i.e. Japan) and invest in a high

yielding currency (i.e. Mexico). Generally, there is liberal use of leverage as well. If currency rates remain stable and interest rates maintain their spread, this can work out to a tidy profit. However, if currency prices de-stabilize (yen gets strong, peso gets weak) at the same time that prices begin to drop for debt instruments, this trade rapidly unwinds. Add the fact that you have leverage and a big squeeze takes place. Selling begins and exacerbates the entire situation creating a tailspin.

Another concern is the number and size of private equity deals being done and the prices paid. Some feel the frenzy is creating overpayment for listed equities – most of which is being funded by low quality bonds. The fact that Blackstone is considering an IPO may be a signal that they are trying to create a liquidity event at what may prove to be a top in this market.

The default rate in variable mortgages in the prime area is also increasing, adding to the concern that the sub-prime fallout is not isolated. As the teaser rates or 5 year fixed rate periods expire, sticker shock is hitting the average homeowner. As well trained consumers, they have funded their purchases via their home piggy banks (home equity loans) and are must now pay the piper. Since lenders are increasing the stringency of their loan requirements, some of these folks may find themselves unable to re-finance their debt. I believe foreclosures will continue to increase.

So what does all this mean to you? What should you do in your portfolio? Does this affect your financial objectives?

Assess the risk in your portfolio:

Don't be lulled by a good quarter in the market. The run-up in the equity markets in the last quarter of 2006 has left investors a bit apathetic about how much risk they are taking. Be sure your asset allocation is appropriate for your downside risk tolerance.

Review your bond portfolio:

Rates in general on most bonds have not been compelling over the last few years. Be sure that you have not traded a slightly higher income for a much higher risk level in your bond portfolio.

Seek Alternative or hedging mechanisms for your portfolio:

We live in a global world where many markets move in synch. Be sure you have some non-correlated assets whether it is an actively managed portion of your portfolio, inverse ETF's (exchange traded funds which do the opposite of their respective benchmark) or alternatives such as energy, oil and precious metals.

Keep Cash for short term needs:

If you have a pending financial obligation (college tuition, new car purchase, paying down debt, etc.) be sure you keep those funds very liquid to prevent losing value with no time to make it back.

Assess Your Debt Levels:

Review all your liabilities and be sure you are aware of any increases in mortgage obligations and what this means to your monthly cash-flow. If you have an ARM with a lock-in rate due to expire shortly, review what a higher rate will mean in actual dollars. Be sure you are prepared.

As always, feel free to call us with questions or comments.

Who is Chapin Hill?

Chapin Hill Advisors, Inc. is a boutique financial planning and investment advisory firm, providing our services to high net worth individuals or business owners. We use the full range of investment products and employ a core and satellite strategy to better facilitate the implementation of specific strategies.

We pride ourselves on the delivery of great service. Our delivery of service is customized to the clients needs and includes quarterly reviews as well as regular communication based on what you desire.

The Chapin Hill Advantage

A unique, process-driven approach to financial advice that combines expert financial knowledge with high-touch service, resulting in a personal investment strategy that leaves clients feeling confident and having “peace-of-mind”. We take the time to understand you prior to making any recommendations. Our planning process covers *The Seven Tenets of Planning*: retirement, education funding, risk management, cash flow/debt management, taxation, estate planning and investment management. Our process can determine your probabilities of success based on the most appealing scenario of your choice.

The Chapin Hill Advantage was created by our founder Kathy Boyle. She has over 15 years’ experience within national and regional investment banking and brokerage firms prior to founding Chapin Hill in 2000. Kathy is a regular commentator and guest on national television shows such as **CNBC’s Power Lunch**, **NBC’s Nightly Business News**, **ABC’s Businessweek TV**, **Fox’s Your World with Cavuto** and **Bloomberg** radio and personal-finance shows.

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