

UCF Fixed-Income Fund Avoids Sub-Prime Mortgages

No Sub-Prime Mortgages in UCF Fixed-Income Fund

-- By Andrew Russell, Director, Fixed-Income Investments, Pension Boards-UCC

Posted 12/12/2007

Almost every day since the beginning of the summer, newspaper headlines have featured stories about the U.S. mortgage and credit crisis. Large losses in the subprime mortgage market have adversely affected several bond and money-market funds.

Investors have been unnerved by events where some funds have disclosed major losses and others have required capital infusions to shore up underlying asset values. Fortunately, the UCF Fixed-Income Fund has avoided these problems.

There are three main reasons why the UCF Fixed-Income Fund has never delved into the world of subprime:

1) Fundamentals --

When we assess the credit quality of a mortgage investment, we consider many factors that give us comfort that a borrower has the wherewithal and motivation to make timely payments.

We favor owner-occupied, well-documented mortgage investments where the borrower has made a substantial downpayment and established a reasonable amount of owner equity. This lessens the possibility that a decline in property values would cause a homeowner to simply walk away from his mortgage.

We favor mortgages in which principal and interest are paid monthly and we avoid "teaser" rates that entice borrowers to borrow more than they can realistically afford.

Subprime credit, which constitutes roughly 12% of the overall market, is the riskiest class of mortgage credit. Some types of mortgages offered to subprime buyers included "interest only", "no money down", "no documentation" and of course the catch-all, nicknamed "NINJA," which stands for no income, no job or assets!

Many securities backed by subprime loans were originally assigned AAA ratings due to what now have proven to be unrealistic assumptions about delinquencies, foreclosures, cash flows and the belief that the U.S. housing economy would remain relatively robust.

Our assessment concluded that many subprime mortgages originated in the last several years under loose underwriting standards were not good credit risks and so we avoided them.

2) Valuation --

Over the past several years as the bond market experienced an "irrational exuberance," investors grew content to accept a very low yield for riskier investments.

Alan Greenspan's oft-quoted and frequently paraphrased sentiment "History has not dealt kindly with the aftermath of protracted periods of low risk premiums," means simply that what goes up must come down.

Subprime mortgages along with other types of risky assets, especially those that were AAA-rated, were being sold at very aggressive levels, especially when compared to other relatively more conservative offerings.

Basically, the entire market was "priced to perfection." This was hardly a time to be making investments in newer and untested types of securities; especially subprime where steep market valuations left little room for error regarding delinquency and foreclosure projections.

3) Style --

We adhere to a disciplined investment process where we maintain a well-diversified portfolio of high quality, relatively uncomplicated bonds that generate an above-market return. We rigorously monitor and control risk and strive to avoid negative surprises.

Yield is a significant contributor to the total return of the fund, yet our style dictates that we not take excessive risk simply to earn a higher yield.

The often complex structures of subprime mortgage investments require analysis that includes a myriad of assumptions, extensive modeling, and the receipt of accurate and timely loan data. Also, higher yielding securities such as these are often less liquid and more difficult to price.

Instead, we look to generate additional return by anticipating trends in relationships among liquid securities with more predictable cash flows, ideally buying cheap and selling dear.

For more information about the United Church Foundation, contact us at **877-806-4989**.