Chair of the Board
Laurence D. Fink (MBA ’76)

Founding Members
David (MBA ’82) and Charlotte Ackert
Robert D. Beyer (MBA ’83)
    David G. Booth
Richard R. Crowell (MBA ’80)
Charles E. Davidson (MBA ’77)
    Joel P. Fried (MBA ’86)
George A. Froley, III (MBA ’61)
B. Kipling Hagopian (MBA ’66)
Timothy D. Jensen (MBA ’88)
Richard A. Kayne (MBA ’68)
Raymond Kennedy (MBA ’88)
Martin C. Murrer (MBA ’81)
    Ben Nickoll
Timothy M. Pennington, III (MBA ’66)
Edward W. Wedbush (MBA ’57)
Richard S. Wiley (MBA ’80)

Advisory Members
Matthew Barrett (MBA ’86)
John R. Casaudoumecq (MBA ’85)
    William L. Davis
Jeffrey S. Deutschman (MBA ’81)
    William O. Grabe (MBA ’63)
Stephen A. Greene (MBA ’85) and Mary C. Don (MBA ’85)
    David Hou (MBA ’92)
Christopher D. Jennings (MBA ’80)
    Chris M. Kanoff (MBA ’84)
Dennis J. (MBA ’80) and Karen S. (MBA ’81) Keegan
    O. Kit Lokey (MBA ’67)
Laurie R. (MBA ’81) and Thomas E. McCarthy (MBA ’80)
    Mitchell J. Milias
Karlheinz Muhr (MBA ’85)
    Joan A. Payden
    Robert W. Schult
Leland L. Sun (MBA ’86)
    J. Fred Weston
David Windreich (MBA ’83)
Are CDOs to Blame?

Dr. Pansy L. Yang | Executive Director
Fink Center for Finance & Investments

Collateralized debt obligations (CDOs), like many arcane derivatives on Wall Street, occupy a vast share of the markets and yet did not become a household name until recent months. Involvement with these securities has taken down major U.S. financial institutions, and has had rippling effects, wrecking international markets as well.

Take Jupiter High-Grade CDO V, "one bad bond" (Time, March 9, 2009), as an example of a CDO that seems to capture the root of the crisis. Jupiter is composed of the riskiest portions of other bonds, and although virtually impossible to value, 93% of Jupiter's bonds were rated AAA when issued in March 2007. Now some top bond traders estimate it's possibly worth as low as five cents on the dollar. Can you say toxic? While many factors are involved, insufficient transparency in the CDO market, significant changes in underlying assets, and the failure of credit rating agencies to accurately assess market risk all played a role in the rapid devaluation of CDOs.

Stuart Gabriel, Arden Realty Chair and Professor of Finance at UCLA Anderson and Director of the Ziman Center for Real Estate, brings with him more than 20 years of research and knowledge on macroeconomics and mortgage pricing. His article is based on his recent research exploring the relationship between CDO issuance and the spread between Treasuries and subprime mortgage-backed securities.

William Petak, Managing Director and National Head of Origination of the Mortgage Lending and Real Estate Department of AIG Global Investment Corporation, provides the industry perspective this issue. His ruminations include a historical look at the development of CDOs, the impact of mark-to-market pricing in these market conditions, and some thoughts on reform.

Special thanks to the UCLA Ziman Center for Real Estate for assistance with this issue of the bulletin.
Recent years have witnessed a boom-bust cycle of explosive growth and then stunning collapse of the global market for collateralized debt obligations (CDOs). Introduced in the late 1980s, CDO issuance took off at the beginning of the current decade, reaching roughly $552 billion in 2006. In the wake of the implosion and wholesale repricing of credit risk in the capital markets that began in 2007, CDO issuance plummeted to about $11 billion in 2008.

Because CDO issuance played an important role in the market for subprime mortgage-backed securities (MBS), this striking rise and fall provides an excellent laboratory for studying the interest rate spreads on the underlying subprime MBS collateral. In particular, the surge in issuance of CDOs backed by subprime MBS coincided with a marked narrowing in subprime MBS-Treasury spreads, while the implosion of the CDO market in 2007 coincided with a marked widening in those spreads. This suggests some measurable effect of CDOs on the balance between the supply of and demand for, and, therefore, the pricing of, subprime MBS. This Brief reports on recent research on this issue by Deng, Gabriel, and Sanders [2008].

A brief overview of CDOs. CDOs are typically designed by investment banks. They involve purchasing a portfolio of fixed-income assets, including such asset-backed securities as subprime MBS, financing the purchase by slicing the portfolio into tranches, which offer different levels of risk and return, and then issuing the tranches in the capital markets. For example, a cash CDO is a senior-subordinated structure, where the senior CDO debt tranches are paid first, then the mezzanine and lower-subordinated notes, and any remaining cash flow is available to equity. Though the rules for distributing the cash flows of the underlying collateral are fairly straightforward, the valuation of the tranches can be quite complicated because the underlying collateral is very diverse in terms of the types of assets, the credit exposures, and the risk profiles.1 Thus, in the CDO structure, a set of assets (such as corporate bonds, commercial MBS, or residential MBS) can be packaged into claims and sold to investors. As Table 1 shows, from 2003-2007, the riskier subprime and Alt-A MBS overwhelmingly dominated other mortgage products (such as prime and second mortgages) as the collateral for CDOs.2

Figure 1 plots the issuance of subprime CDOs and the spread between subprime MBS and Treasuries for the decade from 1997 to 2006. The issuance of subprime CDOs moved up fivefold during the second half of the decade—from about $5 billion in 2000 to in excess of $25 billion in 2006. Clearly, the rise in CDO issuance during that period coincided with

---

**Table 1: Residential Mortgage Deals in 420 ABS CDOs**

| Number of Deals by Vintage and Mortgage Loan Type |
|-----------------|-------------|-------------|-------------|-------------|-------------|
| Vintage | Subprime | Alt-A | Seconds | Prime | Total |
| 2003   | 215      | 63     | 7        | 144     | 429       |
| 2004   | 371      | 252    | 25       | 188     | 836       |
| 2005   | 488      | 452    | 62       | 209     | 1,211     |
| 2006   | 522      | 487    | 69       | 142     | 1,220     |
| 2007   | 150      | 113    | 21       | 28      | 312       |
| Total  | 1,746    | 1,367  | 184      | 711     | 4,008     |


---

1 Several practitioner-oriented papers provide excellent discussions of the CDO market, e.g., Goodman and Fabozzi [2002], Li, Roy, and Skarabot [2004], Roy and Shelton [2004], and Tavakoli [2003].

1 Alt-A mortgages are generally riskier than prime mortgages, typically because the mortgage terms are riskier (higher loan-to-value or debt-to-income ratios) or because of inadequate documentation of the borrower’s income.
a substantial narrowing of the spreads between Treasuries and subprime-backed mortgage-backed securities. Indeed, the spreads of subprime MBS trended down from a high in excess of 500 basis points in 2000 to about two-fifths that level four years later. Increased demand for subprime MBS products, for purposes of derivative securitization via the CDO vehicle, may have served, all other things equal, to depress subprime MBS spreads. More recently, during the latter half of 2007, CDO issuance fell dramatically, to $121 billion. During that period, subprime MBS, which are the underlying collateral for many CDOs, began to experience sharp deterioration in performance, due to marked increases in subprime mortgage delinquencies and defaults. In the wake of sharp erosion in collateral performance, spreads began to widen markedly in both subprime MBS and CDOs, and the issuance of CDOs began to decline. By 2008, issuance of CDOs backed by subprime MBS had ceased.

**How CDOs might have affected subprime MBS spreads**

In examining the relationship between the spreads on subprime MBS—the collateral underlying many CDOs—and the volume of CDO issuance, we build on the prior literature in evaluating the determinants of spreads on MBS.

In a discussion of the 2008 credit crisis, Gorton [2008] assesses CDO structure and issuance. In particular, he identifies rating-related arbitrage as a primary motivation for CDO issuance. Further, the opportunity for negative basis trades may have been important to CDO purchases of subprime MBS bonds. Although recent studies have focused on CDO pricing and issuance, little research has attempted to assess the direct impact of CDO market evolution on spreads in the underlying collateral.

---

3 Gorton suggests that by 2005, yield spreads on subordinated subprime MBS tranches were elevated relative of other structured products of similar ratings, providing an opportunity to arbitrage the ratings between the ratings on subprime MBS and on the CDO tranches.

4 Such negative basis trades could occur if yields on CDO tranches exceed required payment for credit risk protection (in the CDS market). Originators of structured products had an incentive to engage in ratings-related arbitrage to the extent spreads on subprime MBS tranches exceeded those on similarly rated CDO tranches.
Several other hypotheses also may account for the effects of the CDO market on the pricing of subprime MBS. One is the "market completion hypothesis." This holds that CDOs enhanced efficiency in the subprime MBS markets because pooling and re-tranching these lower-rated and relatively less liquid securities makes them more tradable. In addition, a liquidity premium associated with senior CDO tranches may have reduced the cost of raising capital through tranches below the cost of acquiring the asset pool (see, for example, DeMarzo and Duffie [1999] and Demarzo [2003]). If the supply of subprime MBS were not very responsive to CDO issuance, then, other things equal, CDO-related increases to subprime MBS demand would lead to a narrowing in subprime MBS spreads.

The "supply shift hypothesis" holds that the capitalization and growth of the CDO market could induce a supply response, in the form of increased sales of subprime MBS. Those sales might derive from opportunities for improved price execution and/or enhanced outlets for liquidating investors’ residential MBS portfolios. As suggested by Greenbaum and Thakor [1987], the advent of new securities markets allows financial intermediaries to remove assets from their balance sheets and reduce other costs of holding debt. All things equal, this hypothesis would serve to depress subprime MBS prices and concomitantly result in wider MBS-Treasury spreads.

Indeed, prior research has suggested the importance of sector-specific supply/demand imbalances in the determining yield spreads. Collin-Dufresne, Goldstein, and Martin [2001] show that monthly credit spread changes are largely driven by supply/demand shocks that are independent of both credit-risk factors and standard proxies for liquidity. Duffie and Singleton [1999], controlling for credit-risk and liquidity factors, find that swap market supply/demand shocks drive unexplained changes in swap rates. Similarly, supply/demand shocks appear important to analyses of Ginnie Mae yield spreads (Boudoukh et al. [1997]). Evidence also points to the role of supply/demand imbalances in the determination of other residential mortgage yield spreads (see, for example, Bradley, Gabriel, and Wohar [1995] and Lehnhert, Passmore, and Sherlund [2008]).

A third hypothesis, a simple "shell game hypothesis," holds that elevated demand for subprime-backed MBS might have been driven by inaccurate CDO underwriting or ratings, misinformation, misrepresentations, or lack of full understanding of the risks of the CDO vehicle. Some combination of those factors could explain narrower subprime MBS spreads. Fourth, the "asymmetric information hypothesis" holds that CDO issuers may have private information regarding asset returns and engage in related price discrimination via tranching to maximize profits (Oldfield [2000] or use such pooling and tranching methodologies to diversify risk (DeMarzo [2005]).

Finally, there is the "production efficiency hypothesis," whereby specialization and vertical disintegration of such functions as MBS securitization, ownership and servicing, would enhance production efficiency and thereby decrease MBS production costs. This hypothesis derives from well-known work by Greenbaum [1986] and Hess and Smith [1988] which posits gains from specialization of activity in each step of the intermediation and securitization function. Here we would similarly anticipate some narrowing in subprime MBS spreads.

Results. We used various empirical specifications to identify CDO issuance effects on the spread between Treasuries and subprime MBS. This involved first identifying and then controlling for factors other than CDO issuance that would affect the subprime MBS spread. These factors included termination risks of the underlying subprime mortgages, which are affected by interest rate volatility, the term structure of interest rates, and changes in credit risk in the macroeconomy. We also found that subprime MBS spreads showed only limited sensitivity to returns and related return volatility among alternative asset classes, notably including those of equity markets.

Holding all of those factors constant, our results indicate that changes in CDO issuance were associated with significant changes in the spread between Treasuries and subprime MBS. The growth of the CDO market is associated with a contraction in the spread, while declines in the CDO market are associated with significant widening of the spread. For example, a one-standard-deviation negative shock to (ln) CDO issuance over a period of 3-, 6-, and 9 months, results in a widening of subprime MBS/Treasury yield spreads by 110 bps, 150bps, and 170 bps, respectively.

It is likely that the CDO effects were passed back to borrowers in the primary market. Thus, as the CDO markets collapsed in 2007, and subprime mortgage pools lost value precipitously, subprime borrowers faced markedly higher interest rates. Accordingly, our results provide systematic evidence linking the boom-bust cycle in derivative CDO markets to the pricing of subprime mortgages.

These findings highlight the importance of innovations in derivative securities markets to the pricing and related affordability of subprime mortgages. They also indicate that the unexpected closure of the CDO market exerted upward pressure on MBS spreads, and in so doing contributed to changes in the pricing, underwriting and related demise of subprime mortgages.
REFERENCES


Deng, Yongheng, Stuart A. Gabriel and Anthony B. Sanders, 2009, CDO Market Implosion and the Pricing of Subprime Mortgage-Backed Securities, UCLA Anderson School of Management working paper


Goodman, Laurie and Fabozzi, Frank, 2002, Collateralized Debt Obligations Structures and Analysis, John Wiley and Sons, Hoboken, New Jersey


Greenbaum, Stuart I., 1986, Securitization, Asset Quality and Regulatory Reform, BRC working paper no. 147, Northwestern University, Evanston, IL.


Li, D., R. Roy, and J. Skarabot, 2004, A Primer on Single-Tranche CDOs, Citigroup Global Structured Credit Research, Citigroup, New York, NY


Stuart A. Gabriel is director of the Ziman Center for Real Estate at UCLA and is Arden Realty Chair and professor of finance at UCLA Anderson School of Management. His research focuses on topics of real estate finance and economics, housing and mortgage markets, urban and regional economics, and macroeconomics. Prior to joining the UCLA faculty, Gabriel was the Lusk Chair in Real Estate and professor of finance and business economics at the University of Southern California. He also previously served on the economics staff of the Federal Reserve Board in Washington, D.C. and was a visiting scholar at the Federal Reserve Bank of San Francisco. He holds a Ph.D. in economics from the University of California, Berkeley.

Gabriel has published approximately 60 articles in economics and finance journals and serves on the editorial boards of seven academic journals. Gabriel is the winner of a number of awards for both teaching excellence and for the quality of his published work.
Subprime CDOs, The Poster Children of Today’s Economic Woes, But Only One of Many Culprits

William M. Petak | Managing Director, Mortgage Lending and Real Estate, AIG Investments

As we look into the rearview mirror, it is possible to identify many culprits that helped perpetrate the abuse of a system that has led to our current financial woes. In conjunction with avarice, the crisis in the capital markets has its roots in misplaced ideas and errors in policy, accounting, finance, banking, and in business in general, as well as in the poor financial decisions of many Americans. All of these factors have conspired to cause an unprecedented “meltdown” of the financial system in the United States and around the world. Sadly, the current situation is not just a subprime mortgage issue, but also the result of well-intentioned efforts by regulatory, accounting and business leaders and authorities to create and/or improve capital market function. Despite good intentions, the outcome is a destabilized global financial system characterized by low levels of investor confidence and market liquidity. In the midst of all this, however, stands the poster child and what has been considered the initial contagion factor associated with the widespread economic turmoil: the proverbial “subprime” mortgage.

Subprime mortgages were originated to borrowers with limited financial capacity and poor credit histories who borrowed up to 100% of the value of a house. Historically, the lenders who originated those loans did not worry much about default risk because the subprime mortgages were contributed to trusts that issued bonds called mortgage-backed securities (“RMBS or MBS”) which were subsequently sold in the global capital markets. For the most part, subprime lenders unloaded their risk position within a few weeks, such that the credit risk associated with those loans belonged to other investors.

From 2003 through the first half of 2007, a belief in ever-increasing home values, in conjunction with steadily improving mortgage pricing, made subprime mortgage backed securities (MBS) look very attractive. The market euphoria led to an explosive boom for derivative subprime debt that was ultimately backed, in large part, by subprime loans. Notwithstanding the strong residential real estate environment that these loans were originated into, marketing of residential mortgage backed securities required credit assessment. Because the underlying mortgages were often subprime, credit rating agencies would limit the subprime MBS to a low credit rating. In this way it was typical to persuade credit rating agencies to give the subprime MBS to a low credit score (below BBB-), which meant they would not be considered investment grade. This disqualified the securities from the portfolios of many professionally managed funds.

At this point, the investment banking community (the “Bank”) entered the picture. These banks would re-securitize the subprime MBS, slicing the lower-rated MBS bonds into several different “tranches.” The new securities were called collateralized debt obligations, or CDOs. The idea was to create both safer assets and much riskier ones by slicing up the bonds into equity (high risk), mezzanine (middle risk) and the sought-after investment grade (low risk) tranches. The stress tests of the underlying mortgages were often subprime, credit rating agencies would persuade credit rating agencies to give the subprime MBS to a low credit score (below BBB-), which meant they would not be considered investment grade. This disqualified the securities from the portfolios of many professionally managed funds.

As long as housing prices continued to appreciate, the CDO equity tranches had a larger cushion to mitigate the risk of the original subprime borrowers defaulting. This equity instrument, which was not actively traded on any market, could now be valued at a premium. With appreciation in the underlying home prices, the value of the bonds would appreciate faster than the underlying home prices. With such strong performance, hedge funds were able to entice new investments from non-affiliated third party investors. What started as a limited investment vehicle with a small cash investment could grow as long as home prices were appreciating.

The question became, who would buy the subordinated and lower-rated tranches? The answer came in the form of hedge funds. Often the Bank would simply set up or otherwise capitalize a hedge fund which had the main objective of investing in or trading in the higher-risk equity and mezzanine tranches in CDOs.

In the market for CDOs, banks historically found it relatively easy to sell the investment-grade bonds to financial institutions, insurance companies, pension funds and other institutional money managers. The mezzanine and the equity tranches, however, often proved to be more difficult to dispose of. The concentration of the risk in these tranches limited the potential investor pool.

The answer came in the form of hedge funds. Often the Bank would simply set up or otherwise capitalize a hedge fund which had the main objective of investing in or trading in the higher-risk equity and mezzanine tranches in CDOs.

As long as housing prices continued to appreciate, the CDO equity tranches had a larger cushion to mitigate the risk of the original subprime borrowers defaulting. This equity instrument, which was not actively traded on any market, could now be valued at a premium. With appreciation in the underlying home prices, the value of the bonds would appreciate faster than the underlying home prices. With such strong performance, hedge funds were able to entice new investments from non-affiliated third party investors. What started as a limited investment vehicle with a small cash investment could grow as long as home prices were appreciating.

The subprime-backed MBS market benefited from this enhancement to liquidity. CDO managers at hedge
funds “marked-up” the value of their equity CDO tranches. There were many reasons to do so, not the least of which was the fact that hedge fund CDO managers were compensated on performance based on growth and change in value. The hedge fund further sought to leverage its risk. In so doing, it persuaded unaffiliated lending institutions, warehouse lenders, to lend against the CDO positions. This lending often took the form of a warehouse loan facility. The warehouse lender, with access to low priced capital, took full advantage of the opportunity to lend with a significant positive spread arbitrage. Warehouse lenders often saw the value of their collateral increase. This allowed for additional dollars to be lent by warehouse lenders against their existing CDO collateral, which allowed a hedge fund to purchase more CDOs from the banks, which purchased more MBS bonds from the trusts created to buy the loans from the original mortgage lenders, which provided more loan funds to be lent to subprime borrowers, which created more pressure on home prices, driving them higher.

With this type of liquidity available in the market, the MBS-CDO model grew unfettered. The problems that subsequently arose were associated not only with lax underlying subprime mortgages, but also with conflicted rating agency relationships and the excessive use of leverage. Clearly this example demonstrates how large investment vehicles can be too thinly capitalized and too dependent on ratings and significant amounts of short term debt.

The MBS-CDO machine only got into trouble when home prices turned sharply down. Of course, warehouse lenders could claim the right to sell the bonds if the underlying debt got into trouble. When warehouse lenders realized that the underlying collateral had dropped in value and the loan had become out of balance with the loan terms set forth in a lending agreement, they made margin calls to the hedge funds in order to bring the collateral and the loan into balance. This is where the MBS-CDO machine came apart. If the hedge funds did not have the capacity to put up the capital, the collateral needed to be liquidated in order to pay back the warehouse lenders.

For the most part, the failures of the mortgage markets were straightforward. A long period of increasing home prices, with only brief periods of localized weakness, lulled the market into believing that residential mortgages were of very low risk. From the vantage point of those who invested in securitized pools of loans, the risk of losses was considered to be mitigated by the large number of assets in the pools. Additionally, in the case of the senior tranches of the securitized structures, the existence of subordinated tranches available to absorb losses at levels many times greater than historic norms also led to perceived risk mitigation. This resulted in the notion that the most senior tranches were virtually risk-free, and the bonds traded accordingly.

The reality is that, with such a concentration of risk in a falling market, the thinly-sliced and overleveraged equity tranches hemorrhaged value. It’s incredibly costly, in terms of capital, for a bank or any institution holding this type of paper to mark-to-market the value of a holding. Under these circumstances, write-downs or recognition of value impairment are often deferred until the Bank can no longer ignore the issue. This can weigh heavily on a balance sheet which must reflect the write-downs, which will require impairment reserves to be posted. Often warehouse lenders can be presented with a very unfortunate reality when they try to remedy the situation through a sale of collateral. They find that the collateral is simply not worth the price it was last marked at on the books, and the sale would generate a loss. Hence, another problem in this unruly economic environment is the impact of mark-to-market pricing, and the 2006 implementation of the “Fair Value” accounting rule.

The Fair Value accounting standard, FAS 157, mandates “exit pricing” for securities positions including MBS and CDOs. While this is consistent with recent trends in accounting theory, to value assets as if in liquidation rather than as if the assets are an ongoing concern, creates the practical effect of significantly impairing market liquidity for all types of assets. In effect, FAS 157 requires the immediate write-down from the purchase price to a liquidation value of each position. Given the wide bid vs. ask spreads, this limits the appeal of secondary trading and effectively increases the capital costs of holding securities. Theory, however, is not what we are speaking to here. Instead, we are referring to a regulatory trap that has been created as an unintended consequence of a well-meaning accounting rule. In the meantime, short sellers in the market have tried to exploit this condition, further impacting institutional capital as well as the cost and potential of borrowing among institutions. FAS 157 was clearly not well-suited to an illiquid market environment.

Alone, subprime mortgages and CDO structures should not have triggered a global crisis. The actual structure associated with securitization (MBS and CDOs) can be an efficient structure, but was abused by the use of excessive leverage, poor underwriting, and rating activities. Moody’s estimates that total U.S. residential mortgage losses will ultimately reach in excess of $650 billion. This pales in comparison with the value of all financial assets, including stocks, bonds, commercial mortgages and bank loans. For the United States, losses on these assets totaled as much as $60 trillion in 2008, according to Moody’s.
Given the size of our financial system, subprime losses should have been handled without too much disruption of financial markets. At first glance the government’s response to the subprime issues also seems to be larger than the problem. It has taken over the government-sponsored entities of Fannie Mae and Freddie Mac, along with significant positions in companies like AIG and Citigroup; the Fed has been pumping out short term loans, and Congress continues to attempt to deal with a rescue through TARP and TALF.

Still, the situation has not stabilized and the crisis continues. What is going on? What we see is that the real problem is much bigger than subprime mortgages. Much like the CDO example, large parts of the financial system are too thinly capitalized and very dependent on short term debt, which has become difficult to obtain. Leverage ratios reached 20 or 30:1 in some cases for investment banks and hedge funds. The assumption was that institutions knew how to manage risk. Obviously this was not the case. The limited amount of capital on their books did not adequately protect against losses. Trust and confidence have evaporated, and in this illiquid environment, no one is truly sure which institutions hold suspect securities, how extensive losses may be, and which institutions are safe.

De-leveraging, the shift from excessive debt to a balance sheet with more capital, is inevitable and desirable over time. The trouble is that in the short run, de-leveraging can cause great instability in the economy if it occurs too rapidly. Consider the stock market as an example. The market plunge has been driven in part by hedge fund selling. Hedge funds often buy stocks by borrowing from “prime dealers” such as Goldman Sachs and Morgan Stanley, which in turn borrow from the commercial banks. As banks de-leverage through the reduction of loans to prime dealers, the prime dealers tighten up on hedge funds, which must respond by monetizing their stock positions. We see this phenomenon throughout the world. But if credit is withdrawn from the greater market too abruptly, as it has recently, the prices of bonds, stocks and other assets will fall, along with the real economy and jobs.

The current market turmoil and credit freeze will likely continue until orderly, rather than abrupt, de-leveraging can occur through the infusion of new capital for institutional balance sheets. Given the current standards and policies related to mark-to-market and "fair value," this will not happen without substantial pain. Accounting policy reform cannot directly reduce home foreclosures or alter the underlying economics of the lending business, but it may be able to help those institutions that are facing insolvency and continued write-downs on otherwise performing loans to hold these assets to maturity. Current market conditions have created a nearly impossible task of valuing assets, which will continue to keep the secondary market relatively frozen. Any reform should address leverage limits, capital adequacy, rating procedures and accounting policy. The investment and finance community at large will have to re-examine their respective motives, control their avarice, and re-evaluate their risk appetites to reflect a new market paradigm in the relationship between borrower and lender. It will ultimately take well-managed "private capital," in conjunction with healthy banks and financial institutions investing in fixed income products at reasonable yields, to jumpstart the market and bring confidence back to main street investors and banks. Without the foregoing we are destined to continue in this painful write-down and de-leveraging quagmire for some time to come.

William M. Petak has over 24 years of experience in the real estate industry and currently serves as managing director, and national head of origination, of the Mortgage Lending and Real Estate Department of AIG Investments and senior vice president for AIG Mortgage Capital, LLC. He is responsible for the fixed income group’s nationwide production of real estate investments and mortgage lending. He serves on both the Securitized Products Group Committee and the Global Asset Allocation Committee for AIG Investments.

Prior to SunAmerica Investments’ merger with AIG, Petak was SunAmerica Investments’ senior vice president, and was responsible for SunAmerica’s national mortgage lending and real estate investments as well as its leveraged lease real estate acquisitions. He is a founding member of the Board for the Richard S. Ziman Center for Real Estate at UCLA Anderson and currently serves as chairman. He is also a member of the Life Mortgage & Real Estate Officer Council.

Petak is a graduate of the University of Southern California with a B.S. in finance and business economics and is a member of the Mortgage Bankers Association and the Commercial Mortgage Securities Association.
Adapted from keynote speech delivered January 13, 2009 to the first MFE Class of 2009 at UCLA Anderson.

When I graduated from UCLA Anderson nearly 26 years ago, I accepted a job on Wall Street at an investment bank called Bear Stearns. I remember vividly arriving the same day as the brand new "microcomputers" as they were called. There were two of them and they sat in their cardboard boxes on the floor of the financial analysts’ bullpen area for a good two weeks before anyone dared to unpack them. They were made by Victor Electronics, and it was pretty exciting to watch our head analyst, a wild-eyed mathematician who literally wore a green eyeshade, as he booted them up, with their dim amber displays and MS-DOS software. The program that he installed with the included six-inch floppy disk was called “Super Calc”, and we all knew the greatest attribute of Super Calc would be the fact that if you discovered you had deducted goodwill expenses from taxable income in error during year two of a 10-year LBO cash flow model, you would not have to manually erase eight years of pencil lead entries to correct the analysis. This was big. We had computers at Anderson (then called “GSM”) but you had to sign up for them in advance, they industrial companies, underwriters, advisors, money managers, banks, insurance companies) that thrive during your generation will be see-through. If you buy a stock, you will know exactly how often the CEO flies on a private plane and whether he takes his wife with him on the trip, you’ll know if he receives an incentive and you’ll know how much your company pays for lobbyists and political influence. You will know how they benchmark themselves against the competition to see how they are performing, how they compensate their employees, and the real value of what they own and what they owe. In the internet age, not only will you get fast information, you will have accurate information.

The second attribute is a high premium on character and responsibility. The 21st century firm will consider continuing education as a necessity to motivate and retain their employees and clients, taking an interest in their career development and their growing relevant sophistication. They will act as responsible corporate citizens, investing alongside their constituents to promote shared success, and on those occasions where things don't work out, empathetic and cooperative disappointments. Know your employee, know your client, know your community. Ethics training and strict policies will attempt to create an honest and fair workplace.

The successful company will establish performance standards so pay is commensurate with results. Companies (be they industrial companies, underwriters, advisors, money managers, banks, insurance companies) that thrive during your generation will be see-through. If you buy a stock, you will know exactly how often the CEO flies on a private plane and whether he takes his wife with him on the trip, you’ll know if he receives an incentive and you’ll know how much your company pays for lobbyists and political influence. You will know how they benchmark themselves against the competition to see how they are performing, how they compensate their employees, and the real value of what they own and what they owe. In the internet age, not only will you get fast information, you will have accurate information.

The successful company will establish performance standards so pay is commensurate with results. How does an investment bank pay $15 billion in bonuses at the same time as it loses $15 billion in market value for its investors? Sure there will exist opportunists who cut corners and drive up commissions,
to enrich themselves at the peril of their institutions, but the tone at the top will be such that the fall guy will be the supervisor and the executives, not just the layoff victims and the shareholders.

Finally, the company you work for will value loyalty and expertise. The quest for extraordinary quarterly profit gains and illogical category dominance will give way to traditional long-term value creation and low turnover. As the student of the latter 20th century searched for ever-increasing challenges and progress, he or she jumped around every few years, wearing multiple careers as a “badge of honor.” Similarly, employers positioned themselves for a highly transient workforce, and spent time maximizing short-term rather than lasting success models.

There is a big future for the next generation of financially savvy, highly trained, ambitious professionals who want to use technology, risk metrics, morality and a long view to their advantage. You’ll be hired because you will come with great potential, few bad habits and the knowledge of what can happen when the power shifts too quickly and too obscurely to those who have no idea how to use it. The future is bright. You are the future of my business. I am honored to speak with you today.

Robert D. Beyer is chief executive officer and a director of the TCW Group, Inc., a Los Angeles-based investment advisory firm with approximately $130 billion of equities, fixed income and alternative assets under management. He is also a member of the executive committee and a director of Societe Generale Asset Management, S.A., the parent company of TCW.

Beyer is a director of the Kroger Co., the third largest retailer in the United States. He is chair of the board of trustees of Harvard-Westlake School and a member of the board of councilors at the USC College of Letters, Arts & Sciences. He is a former commissioner of the Los Angeles City Employees’ Retirement System.

Beyer received his B.S. degree in business from the University of Southern California and his MBA from UCLA Anderson School of Management.

Please consider supporting UCLA Anderson School of Management’s new Master of Financial Engineering Program by hiring a graduate summer intern. Most students already have advanced degrees in mathematics, computer science, engineering and business. These students can make a difference to your bottom line by bringing new ideas to your work place, developing financial models, assisting with financial projections, identifying trends in the marketplace, working on investment strategy and investigating new analytics for your company. This is an opportunity to train the next generation of financial leaders. If you have a place in your company for one or two of these bright students, please contact Sandra A. Buchan, Director of Career Services on 310-206-5042 or e-mail sbuchan@anderson.ucla.edu.
Developments In M&A Activity
Fred Weston, Professor of Finance, Emeritus Recalled

The Mergerstat monthly FLASHWIRE January 2009 (p. 2) reported that the number of M&A deals declined by 30% during the 12 months ending 11/30/08. For the largest mergers with deal size of $500 million and larger, the percent decline was slightly over 50%. The dollar value involved declined by 40%.

During roughly the same period producers’ durable equipment outlays fell about 10% each quarter of 2008. M&As and outlays for business fixed investments are highly correlated. Both are methods used by firms to make investments. The December 2008 UCLA Forecast calls for producers’ durable equipment outlays to decline in 2009 by 20% in Q1, a negative 11.1% in Q2, and a negative 4.7% in Q3, with subsequent increases in 2010. If these forecasts are accurate, we could expect M&As activities to continue to decline in 2009 and then begin to be positive in 2010. These fundamental forces will continue to dominate shotgun weddings between individual companies such as Bank of America and Merrill Lynch in 2008.

UCLA Finance Ph.D. Program Cited #1 in Training

In a paper published in the February 2009 edition of The Financial Review, the UCLA Anderson Finance Ph.D. was cited as “best at training scholars.” The article looks at the joint contribution of the university granting the Ph.D. degree and the institution one is placed at as an assistant professor. The article by Kam Chan, Carl Chen and Hung Fung, is entitled, “Pedigree or Placement? An Analysis of Research Productivity in Finance.” The research study lists the UCLA Finance Ph.D. program as #1 at enhancing the publication record of its students in the top three finance journals. The study also notes the top five universities for an assistant professorship in finance (which includes UCLA). Approximately ten percent of UCLA Finance Ph.D. graduates have ended up at these top five universities and an even greater percentage received offers from them.

UCLA Finance Researchers Prevalent In Forthcoming Research

Approximately 20% of the authors in the upcoming April 2009 Journal of Finance, the research journal of the American Finance Association, are either UCLA Anderson Ph.D. graduates or UCLA Anderson faculty. The authors are: Felipe L. Aguerrevere (UCLA Anderson Ph.D. 2000), Tobias Moskowitz (UCLA Anderson Ph.D. 1998), Mark Grinblatt (UCLA Ph.D. Dean and Professor), Mark Garmaise (UCLA Finance Area Ph.D. supervisor and Associate Professor), and Bruce Carlin (UCLA Finance Assistant Professor).
Cesare Fracassi is a Ph.D. student studying Finance at UCLA Anderson. He recently accepted a tenure-track position as assistant professor at the McCombs School of Business at the University of Texas, Austin. His primary research interest is in the area of corporate finance, more specifically, the role of social networks in corporate policy decisions. Other areas of interest include corporate governance, mergers and acquisitions and executive compensation.

Before starting his Ph.D. he worked as a strategic management consultant at Booz Allen and Hamilton and Roland Berger in Italy, and as a summer research intern at the United Nations in New York. Cesare holds a bachelor’s degree in electrical engineering from Politecnico di Milano, Italy, and an MBA from UCLA Anderson.

Albert Sheen is a doctoral student in Finance at UCLA Anderson. He recently accepted a tenure-track position at Harvard Business School and will be joining their faculty this fall. Before starting his Ph.D. he was a management consultant with McKinsey & Company, an analyst at Beecher Investors, and a research associate with Sanford C. Bernstein. Albert received a bachelor’s degree in economics from the University of Chicago. His research interests are in the areas of corporate finance, particularly public and private firms, internal capital markets and product market strategy.
Finance Area Faculty

Antonio Bernardo, Professor
Michael Brennan, Professor Emeritus
Bruce Carlin, Assistant Professor
Bhagwan Chowdhry, Professor
William Cockrum, Adjunct Professor
Stuart Gabriel, Arden Realty Chair
Mark Garmaise, Associate Professor
Robert Geske, Associate Professor
Mark Grinblatt, J. Clayburn LaForce Chair in Management
Francis Longstaff, Allstate Professor of Insurance and Finance
Hanno Lustig, Assistant Professor
Marc Martos-Vila, Assistant Professor
Richard Roll, Japan Alumni Chair in Finance
Pedro Santa-Clara, Associate Professor
Jon Schneider, Assistant Professor
Eduardo Schwartz, California Chair in Real Estate and Land Economics, Finance Area Chair
Avanidhar Subrahmanyan, Goldyne and Irwin Hearsh Chair in Money and Banking
Geoffrey Tate, Assistant Professor
Walter Torous, Lee and Seymour Graff Professor
J. Fred Weston, Professor Emeritus
Liu Yang, Assistant Professor
Contact us

UCLA Anderson School of Management
Laurence and Lori Fink
Center for Finance & Investments
Entrepreneurs Hall, C424
110 Westwood Plaza
Los Angeles, CA 90095-1481
fink.center@anderson.ucla.edu
310.825.3867

For more information about the Center, please visit us at www.finkcenter.anderson.ucla.edu