Perryman Financial Advisory, Inc.

Three Forest Plaza
12221 Merit Drive, Ste. 1725
Dallas, Texas 75251
Phone: (972)770-4800
Fax: (972)770-4888

The Mark-to-Market Melee

According to a small but powerful group of America's financial decision-makers—mostly supply-siders and those in their thrall—the chief cause of the credit market meltdown is not folly, or reckless lending, or the demise of America's financial management. It's an accounting rule.

"Mark-to-market" is a seemingly innocuous term for the requirement that companies, banks, hedge funds, mutual funds, and the like report the market price of the financial instruments they hold and trade. (Here's some good background from Morningstar.) Mutual funds that own stocks make such a report every day. Publicly held firms like Bear Stearns must do so at the end of every quarter, and hedge funds must do so on a rolling basis to reassure their creditors that the assets they've put up for collateral are still worth something. Mark-to-market is thus crucial to the functioning of transparent markets.

For mutual funds, marking to market is a simple affair. But for those who hold thinly traded assets or assets for which there isn't a ready market (mortgage-backed securities, corporate debt, venture capital investments, etc.), doing so is more of a challenge. In these cases, managers mark to market either by comparing analogous assets or by estimating "what market participants would use in pricing the asset or liability."

In the past five years, Wall Street firms created huge volumes of new kinds of complex securities, such as subprime bonds and collateralized debt obligations, which are investment vehicles built out of subprime bond securities. These securities lacked long trading histories or deep markets. To value them, many outfits slipped the surly bonds of mark-to-market and assigned a value to them based on so-called mark-to-model. (In other words, educated guesses based on algorithms.)

When credit started to go bad, market participants had to write down the value of such assets. For institutions holding onto bank loans—an asset for which there is an active secondary market—marking to market was relatively simple. If markets priced bank debt of companies with a particular credit rating at 85 cents on the dollar, banks had to write down 15 cents of the value of each dollar of the loan. This process helped drive the massive write-downs seen at banks like UBS and Citigroup.

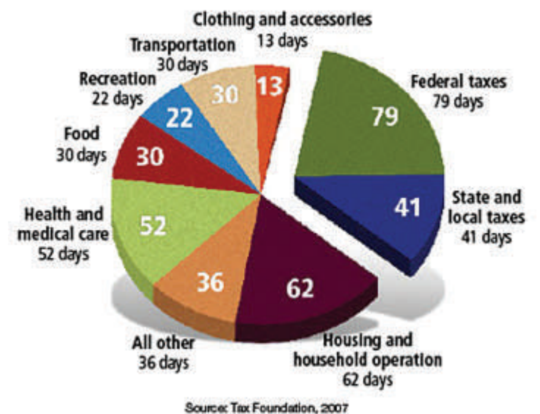
But for the complex new financial instruments, the valuations became far more unstable. Many hedge funds and financial institutions had borrowed huge sums of money to buy assets for which there wasn't an active market. When that debt started to go bad, it triggered a chain of unfortunate events. In many instances, funds were forced to sell assets to meet margin calls. Occasionally, creditors would seize assets and sell them. (That's what happened to the Bear Stearns hedge funds that failed last year.) This spiraling activity had the effect of further depressing prices for such instruments. In some instances, buyers disappeared entirely. The valuations of these new instruments also plummeted because of market psychology. In establishing value for assets, funds and banks often relied on newly created indices, such as the Markit ABX indices. Since those indices are actively traded by investors, they can be driven up and down (mostly down) by speculation and fear. The end result: The banks and funds holding subprime bonds (which is to say, pretty much the entire global financial complex) have been forced to massively cut the mark-to-market value of their holdings because those values are based on the incredibly pessimistic indices.

Continued...

April 2008

- About Us
- Meet the PFA Team
- PFA in the News
- Contact Us
- Calculators
- Web Links

Market Watch		
	4/29/2008	YTD
DJIA	12,831	-3.26%
S&P 500	1,390	-5.27%
NASDAQ	2,426	-8.53%



For the Referrals...

THANK YOU for referring your friends, family, and co-workers. We strive to exceed your expectations ***every time*** and hope you will continue to be an advocate for PFA.

Questions or comments? E-mail us at jperryman@billperryman.com or call (972)770-4800.