

Facing Up to the Subprime Crisis

By Alan Cranfield

The primary result of the collapse of the subprime mortgage market has been thousands of people losing their homes because of adjustable-rate, low-money-down mortgages they probably should never have assumed in the first place. This spectacle has been awfully scary to watch from afar. Most prudent investors, of course, would never borrow the entirety of a mortgage to get themselves into a house they can't really afford, or sign on to make interest payments that are scheduled to go into hyperinflation in three years. So you might think the subprime problems have nothing to do with you.

But they have the potential to reach all of us. This financial crisis, so deadly for many undercapitalized homeowners, has begun to reach into a lot of different corners of the economy, affecting the ways that all of us invest and borrow money. Fortunately, this scandal has been centered in the U.S. and has made only limited impact on the Canadian economy. And while it's certainly something that investors need to keep an eye on, prudent individuals should not have their financial plans be disrupted by the subprime crisis.

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The Rippling Effects

To be sure, the news ricocheting around the financial world has been scary. National Bank of Canada has announced it will take a \$575-million pre-tax writedown because of bad debt investments, much of it the result of the subprime mortgage crisis. Bank of Montreal also wrote down half a billion dollars, including \$320 million from debt-instrument problems. Royal Bank charged \$360-million to U.S. subprime mortgage losses, and Scotiabank said it will book writedowns of \$190 million on non-bank asset-backed commercial paper and structured credit instruments. CIBC disclosed a \$463-million writedown.

The Canadian economy as a whole is also likely to suffer from the subprime crisis. The IMF has cut its 2008 growth forecast for Canada to 2.3 percent from its July forecast of 2.8 percent, and the Canadian dollar has begun to drop. But for investors, the question is, are these issues of the type that should cause me to rethink my financial strategies, or are they problems I can avoid with some careful planning? Let's take a more in-depth look at some of the ways the subprime crisis may affect the individual investor.

Everyone recognizes that the big players in the U.S. subprime market could be headed for some very dark days, like Countrywide, which recently had to borrow \$11.5 billion to help cover its loan portfolio, and the U.S. mortgage giant Freddie Mac, which lost almost a third of its value in a single day. The damage to the Canadian banks, which we noted above, has not been nearly that bad.

The problem has the potential for spreading out for a while, into the institutions that bought these subprime loans, hoping to take advantage of the sizable interest they were throwing off and ignoring the risks that the high-risk borrowers wouldn't be able to pay all that money back. In a way, it's reminiscent of the junk-bond meltdown of the late 1980s, when investors craved the high yields those bonds were paying and forgot about the reason they were called "junk" in the first place. Bear Stearns, Citigroup and Merrill Lynch have all cashiered their head men for making bad calls on those investments.

Other industries have been affected by the crisis as well. Because of the increasing number of foreclosures, the market for new housing is weak. The two largest retailers in America, Wal-Mart and Home Depot, both reported disappointing earnings this summer, blaming the slowdown in the housing sector, and their stock prices reacted accordingly.

Those foreclosed mortgages have dumped a lot of housing on the market, and the removal of all those people with shaky credit from the homebuying pool has reduced the number of potential homeowners. That adds up to a flat housing market, one that could continue to be weak for a while. The value of your home and your vacation home may be stagnant for some time as well. It's bad news if you were planning to sell real estate in the near future, but it could be to your advantage if you're looking to buy.

Most obviously, the subprime crisis is deadly for those who were still hoping to get mortgages for little or no money down, but anyone who wants to borrow money can expect it to be a little more expensive going forward. There have been reports of a crisis of confidence among bankers, who aren't sure how to price their loans anymore. Interest rates have begun to creep higher, not just for mortgages, but for credit cards as well.

Taking Action

So how should investors react to these repercussions, which may be with us for a while? Perhaps the easiest aspect of the subprime issue to deal with is the losses by the major financial institutions, both here and in the U.S. A prudent investment plan, with proper asset allocation, will be well-diversified across industries and vehicles, so that a downturn in any one part of the market will not be unduly problematic.

The fact that there are current problems in the financial-services industry may make the losses more visible, but for investors, it's really no different from problems in any other industry. In fact, a carefully constructed investment portfolio expects some of its holdings to decline in value from time to time. In that sense, a turndown in finance is the same as a turndown in high tech or light manufacturing.

The real estate issues are similar. Investors with long-term financial plans expect some short-term ups and downs in their investments, whether that's their stock holdings or the properties they own. Real estate prices and mortgage interest rates are expected to fluctuate, but the only date when they really matter is the day you're buying or selling property.

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That's the crux of the issue for investors dealing with the subprime crisis: It's a crisis for those without careful, long-term plans, for people whose fortunes rose and fall on the events of any given day. On the other hand, for those who have set out their long-term goals and established serious financial plans designed to meet them, the subprime crisis shouldn't be any more of a concern than the tech bubble was, or any of the other upswings and downturns that are a natural feature of the economy.

About the Author

Alan Cranfield is a Principal with Stonegate Private Counsel LP. Alan specializes in helping seasoned business executives and entrepreneurs gain financial peace of mind so they can spend more time enjoying their loved ones, maintaining their health and living life to the fullest. Alan has dedicated the past 20 years to helping his clients establish and attain their financial goals. He has earned the professional designations of CERTIFIED FINANCIAL PLANNER® (CFP®) and Registered Financial Planner (R.F.P.). Over the past two decades, Alan has studied advanced counselling, coaching, listening, business management and investment strategies with top industry experts. Alan's practice is limited to fewer than fifty clients who meet not only financial criteria, but who are also compatible in personality. New relationships are created through personal introductions from clients and through social contact, not marketing. This frees Alan's time to be spent developing meaningful, long-lasting relationships with his clients. Outside of work, Alan is a member of the Antique and Classic Boat Society, Muskoka Heritage Society and Muskoka Lakes Association. He is an avid snow skier and has enjoyed a lifelong interest in personal development and business success. Alan has homes in Toronto; Muskoka; and Fort Myers, Florida.

Alan's affiliation with Stonegate Private Counsel LP enables him to offer clients access to a team of experts in money management, asset allocation, portfolio design, rebalancing, tax optimization, estate planning and asset protection.

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