Should You Invest In Toxic Assets?

A Mutual Fund Will Allow Ordinary Investors to Put Their Money Into Mortgage-Backed Securities, But There's Not Yet a Compelling Reason to Invest.

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Who wants to buy some toxic assets?

It may not sound like the most tempting offer—but don't be shocked if you hear this same pitch from your financial adviser sometime soon.

New York-based fund giant BlackRock is launching a closed-end mutual fund aimed at allowing ordinary investors to put their money into the kind of toxic mortgage-backed securities that nearly brought down the financial system a few months ago. Shares are expected to go on sale in about a month.

The BlackRock Legacy Securities Public-Private Trust will be sold through brokers and advisers. It will try to buy mortgage-backed securities at distressed prices from banks looking to shore up their battered balance sheets. The fund will invest alongside the U.S. Treasury as part of the Public-Private Investment Partnership, or PPIP, launched earlier this year. BlackRock is among a small group of firms picked to take part in PPIP.

Should you invest?

It's hard to make a compelling case at the moment. But the fund is worth watching.

For one, it goes against the herd. Some of the best investments come from assets that everyone else is too scared or uncertain to buy. Financial salvage can be very profitable for the brave.

Some of the banks holding these securities may be eager to sell because they need the money. Other banks already have written down the value of these securities on their books to very little. If they can sell them for more than that, they have an incentive to do so and book a short-term profit.

The fund will also benefit from helpful financial engineering courtesy of the U.S. government. PPIP was set up to encourage private investors to help bail out the financial system. So for every dollar invested, Uncle Sam will provide another $2—$1 in equity and $1 in debt. The debt's cheap, too: about two percentage points over the LIBOR interbank rate. That should boost returns.

Sources are hoping that, when you factor in the financial engineering, the fund will be able to earn maybe 10-12% annually over its ten-year life. That would be a pretty good return.

But that's a guess, nothing more. The results may be quite different. Fine words, as my English grandmother would say, butter no parsnips.

And there are ample reasons for concern. The main reason to invest in these securities would be to buy them cheaply from desperate, forced sellers. But the banks may not want to sell after all. That of course raises the risk that you may end up owning the toxic assets the banks don't want.

"For now, the bulk of toxic assets are not going to be in play," Harvard law professor Lucian Bebchuk, one of the intellectual architects of PPIP, told me. Changes to accounting rules and government stress tests, have taken off some of the pressure off banks, so Professor Bebchuk says banks are not as motivated to sell their toxic assets as they were when PPIP was set up in March. "For many types of toxic assets, even if the banks can get a price that's fair, if it's at a discount to face value they don't have an incentive to do it," he says.

Furthermore, thanks to the stock market rally the banks are feeling more confident—and have a lot more access to capital.

Prices for mortgage-backed securities have bounced dramatically since the dark days of March.

Meanwhile, the fundamentals of MBS continue to worsen. Fitch Ratings says 6.8% of (non-agency) prime mortgages are now delinquent—twice as many as were delinquent six months ago. The figures for Alt-A are 21%, and for sub-prime, 40%. They're still getting worse. Fitch director Grant Bailey says mortgage delinquency rates won't stabilize until house prices and unemployment rates do.

This isn't BlackRock's first fund invested in toxic assets. Last winter BlackRock raised $307 million from wealthy clients for its Fixed Income Value Opportunities fund, which bought a lot of toxic assets. The fund does not trade, but the net asset value has risen about 18 per cent since it was launched in March. The fund's filings show it was able to buy a lot of mortgage-backed securities, or MBS, for about 80 cents on the dollar.

Americans already have plenty of indirect exposure to mortgage-backed securities through any banking stocks held in their mutual funds. For that matter, there's a link between MBS prices, the real estate market, and the value of your home. You probably don't need to double up.

From a practical standpoint, BlackRock's new fund will be a so-called closed-end one. That means it will have a fixed number of shares, which will then trade on the stock exchange. It is rarely a good move to invest in such funds in an initial public offering. The shares are usually sold for more than their net worth, to pay the brokers. BlackRock says in this case there will be a separate sales commission instead. But stay tuned—after a few months, you may be able to buy those shares on sale.

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