The Delaware Bay Company LLC

"Let the people know the facts . . . and the country will be safe." - A. Lincoln

HINDESight™ March 9, 2021

Fannie Mae and Freddie Mac:

A FRESH LOOK CONFIRMS THE INVESTMENT THESIS.

You can still buy a dollar (or more!) for less than 25 cents.

Purgatory provides a buying opportunity.

The present state of affairs is that most people who have been invested in the GSEs (i.e., "government-sponsored entities") are thoroughly disgusted and demoralized. They are suffering from what I call *"creditor fatigue"*. And with good reason.

After repeatedly committing to getting them out of conservatorship prior to his term ending on January 20th, Treasury Secretary **Steven Mnuchin** basically *"took a powder"*, according to one of my very highly placed Washington sources. As has been reported in the press, the Secretary spent most of the post-election interregnum traveling the world, supposedly on a "farewell tour" of foreign capitals (coincidentally, those with sovereign wealth funds which could be potential investors in his next business venture). *"Clearly his mind was elsewhere"*. Finally, my source – who has a very good relationship with former **President Trump**, says he actually had a 15-minute discussion with the President on January 1, after which Trump assured him he would *"speak with Steven"* and tell him to *"get it done"*. Indeed, I was told *"all the work was done for Q1/Q2* (stock) *offerings"* and that they had already held *"off-the-record roadshows."* But then, as my source put it, *"January 6th happened"*. Fannie and Freddie became a mere distraction as insurrection and impeachment (again!) consumed all the Administration's bandwidth in those last two weeks of its existence. In the meantime, those of us who are long-time investors in the situation watched in horror as the $25 par value preferred shares dropped to below $6 (where they can still be had even as I write).

What has changed?

I will confess that I was as upset as everyone else. But as the old expression goes, *"I've seen this picture before"*. As I have done every time something like this has happened to me in my 40-plus year career on Wall Street, I went back to my training program at **Blyth, Eastman Dillon & Co**. Throw out all your research and start over, we were taught. From scratch. Have the fundamentals of either company changed? (Answer: no; as a matter of fact, both had record earnings last year.) Have the chances of our receiving less than our $25 par value changed? Again, 'no'. Has the timing changed? Yes. Has it changed dramatically? No. So, given all that, I think it's time to give the situation a fresh look, for at these prices Fannie and Freddie preferreds turn out to be, IMHO, examples of a typical **Ben Graham** 'value' investment. (Without the risk of their turning into a 'value trap' – see below.) As you have heard me say before, *"you are buying a dollar for less than 25 cents"*. (And as I point out below, you could be buying *more* than a dollar.)

Bear in mind that we're not talking about a **dot-com** stock here (showing my age!), or **Tesla** or **GameStop** or whatever flavors *du jour* have captured the fancy of the **Reddit** and **Twitter** crowds. We're talking about two of the most profitable companies in the world which happen to operate in a very boring and unsexy sector of the market – insuring home mortgages (for people with average credit scores in the 740s). The outcome of an investment in Fannie and Freddie (preferreds) is basically uncorrelated with the rest of the market. Yet they could end up turning out to be *"five baggers"* from current prices.

I am not going to waste a lot of space filling in the background; as most of you know, I have written numerous pieces about it, so you can start with *The Case of the Concrete Life Preserver*. Better yet, *"Another Big Lie: How the Government Stole Billions from the American Dream of Home Ownership – and Got Caught"* (by my friend and fellow GSE shareholder **Tim Pagliara**) hits bookstores today. (It's also available at **Amazon.com** in either hardcover or **Kindle** versions.) I highly recommend you give it a read. For two companies which operate dull businesses, the story of what happened to them – and why – turns out to be a real thriller.

Four bites at the apple.

Let me be clear: At today's prices, *in my opinion* (and based upon the facts as I know them), I firmly believe that unless someone is forced to sell early, the chances of losing money on this trade are very low. To the contrary, I see four separate pathways to preferreds receiving *at least* par value. One is an administrative solution; the other three involve the courts.

If there is to be an administrative solution, it could be within a year. If not, the three court cases I will describe below are teeing up and the one on the fastest track could finish up in, at most, three years. But should it come to that; preferred holders will be entitled to approximately six percent interest going back to at least 2012. On that basis, the $25 (par value) preferreds already have a claim today of just north of $39. Add three more years and you're pushing $44. The IRR would be phenomenal.

The fact that shareholders need win just one of the lawsuits to in order to collect interest explains why I think a court-imposed solution will most likely never happen. In my opinion, the new Administration will likely want to put Fannie and Freddie behind them and will pick up where the Trump Administration left off. I am sure there will be some tweaks (selling the government's warrants to fund more affordable housing projects?), but I do know that the **Biden** people understand the need to get outside capital into these companies – fast – and that it cannot be done without coming to terms with the existing shareholders and settling their lawsuits. Until that happens, they run the risk of another downturn in the housing markets, which would quickly eat through what little capital the GSEs have been allowed to accumulate, leaving the Administration holding the bag for yet another 'bailout'. (Actually, it would be the return of stolen money.) I expect they will fashion an administrative solution (at roughly par and perhaps as early as year-end) before the courts force their hand (and run up the bill). If they haven't already, they will soon realize what just about everyone else has already figured out: "TINA". *There Is No Alternative*.

Timing now much more clear.

The conservatorships are now in their thirteenth year (and the court cases are in their ninth). Most of the long delays involved with court cases involve what the lawyers call pre-trial "motion practice"; i.e., motions to produce documents and depose witnesses ("discovery"); counter motions to deny or limit discovery; motions to dismiss the case entirely, etc. And, of course, the loser always appeals those pre-trial motions. We've now been through all that and one case is already scheduled for trial next year. At that point, things start to move at a pretty good clip and there normally should be a verdict within a year.[1] Add another year for an appeal and we are looking for a final judgment in about three years. Again, time is on our side as the interest clock keeps ticking throughout.

Collins v. Mnuchin

I list this case first only because a decision is pending from the **Supreme Court**. Originally filed in Texas, this case was argued before the justices on December 9th of last year and a ruling is expected at any time between now and June 30th. Without getting into too much detail, the shareholders are expected to lose their bid to have the Net Worth Sweep ("NWS") declared unconstitutional but are expected to win what is called the "APA claim", which would send the case back down to the trial judge for a "do-over" (in other words, they tell the judge he was wrong on the law in dismissing the case, so now hear it on the facts). But in many respects, it really doesn't matter what SCOTUS decides in the *Collins* case because it is the next one which provides the fastest path to a shareholder win.

Fairholme Funds v. FHFA

The procedural shenanigans now in the rear-view mirror, this case is on the front burner. Like *Collins,* it was initially dismissed by the trial court (Judge **Royce Lamberth** of the **D.C. District**). Also, like *Collins*, he was overruled by the appeals court and ordered to hold a trial. (It later came out that the government had lied to him in its initial pleadings.) Motions for summary judgement are due on October 15 and November 19 of this year, with a trial date (if necessary) set for May 16 of next year. If successful – again, the evidence of the government's misconduct is overwhelming – shareholders would be entitled to par value plus interest (at approximately six percent) dating back to the imposition of the Net Worth Sweep in 2012.

Fairholme Funds v. the United States

This case is in the **U.S. Court of Federal Claims** and once again, the shareholders have successfully fought off a motion to dismiss (although the government is appealing). The

[1] (Given the overwhelming weight of the evidence, the need for a trial could actually be short-circuited by a motion for summary judgment.)

claim asserts that the imposition of the NWS was a "taking" of private property without compensation. Final briefing on the government's motion is due at the end of March, after which a date will be set for oral argument. Expect a decision in late fall. Presuming the shareholders continue to prevail, a trial would most likely begin (if not circumvented by a motion for summary judgement) a year thereafter. Like the case in Judge Lamberth's court, shareholders would be entitled to interest going back to August of 2012.

Bottom line: The longer this goes on the more we make (and the more it will cost the government). Which is why I believe the new Administration will realize that the TINA rule applies here. Fingers crossed for an administrative solution by year-end.

'Premature accumulation'

Ah, yes, I often suffer from that dreaded investment malady. But those of you who were with me at the time will recall that we started buying **Meritor** stock for a penny a share the day after the FDIC closed **PSFS** on December 11, 1992. It took a lot longer than I would have liked for, unfortunately, there was no interest clock ticking and so the government had no incentive to settle.

But in the end, Treasury was forced to write the shareholders a check for $276 million (roughly $4.50 per share). I've never calculated the IRR, but I doubt that it didn't far surpass just about any relevant index.

Gary E. Hindes
March 9, 2021
646-467-5242
gary.hindes@delawarebayllc.com
