THE Neal Spelce AUSTIN LETTER

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P.O. Box 1905 / Austin, Texas 78767-1905 / 512-498-9495 / Fax 512-327-1976 / e-mail **News@AustinLetter.com**

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Dear Client:

No, the animals haven't started lining up two-by-two — yet. After all, this pattern of persistent, and often heavy, rainfall has only continued for 30 days and 30 nights, not 40. Besides the obvious benefits following a two-year drought, there is another little-known value to this rain.

Actually, there was a lot of rain during the early weeks of June, but the torrential downpours that started the floods west of Austin throughout the Hill Country occurred June 27th. This is when massive amounts of water fell in the Colorado River basin and led to near-record rises in Lakes Buchanan and Travis. **Even though Lake Travis has dropped almost 20 feet from its July peak, it is still storing water in its flood pool. So it is more than "full."** And this is where the little-known value comes in.

During "normal" years and certainly during the years of drought, Lake Travis loses water at a rapid pace during June and July, no matter how much water is in the lake – much to the chagrin of those who rely upon lake tourism and recreational activities. **The water is released downstream so rice farmers near the Gulf Coast can flood their fields during the summer growing season.**

But with the timing of this prolonged rain event this summer, there is **more than enough water for the rice farmers**, so the water releases downstream are not noticeable – and everyone benefits.

If you're not a rice farmer and you use Lake Travis for recreational purposes, enjoy it while you can (even though the high water is still somewhat hazardous). **Because, in future summers when "normal" or even drought conditions prevail, that giant sucking sound you will hear will be water pouring out of Travis, flowing downstream to flood rice fields.**

Why? Well, under Texas water rights law "first in *time* is first in *right*." **Rice farmers were given first water rights**, long before the Lower Colorado River Authority (which manages the water flow) existed and the dams and Highland Lakes were created back in the 1930s.

While many are asking when this rain will end, **enjoy the cool temps (it has yet to hit 95 degrees), green grass and trees and the abundant, life-giving water** – at least for now.

The nation's seventh-largest public fund, at a whopping $112 billion in assets, is located in Austin. The Teacher Retirement System of Texas is normally conservative in its investments. But now it is taking a leap that other funds are watching closely to see if it will succeed or fail.

Any way you slice it, $112 billion is a lot of assets. And Texas teachers are justifiably proud of their retirement system. Up to now, it has been downright stodgy in how it has invested its funds. But the new investment officer, **T. Britton Harris IV**, is about to go where no man has gone before – shifting about one-third of its funds into "alternative" investments.

Oh sure, other funds have dabbled in real estate or "hedge funds" in the past. But not to the extent Harris is planning. **He's talking about lumping 30% of his fund's money into these – some call them risky – alternative investments, at a time when there have been some very public failures.**

Those failures: 1) two Bear Stearns hedge funds that invest in **subprime mortgages recently melted down**, and 2) an Amaranth Advisors (AA) pension fund lost $6 billion on **natural gas bets that went wrong** (and AA was sued by the city of San Diego, as a result).

His somewhat modest goal of an increase of 1% annually would generate an additional $1 billion a year. Harris points out that this is a way of diversifying, that alternative funds don't move in lockstep with stocks and bonds. **He is convinced he can get a higher rate of return with the same level of risk.**

To give you an idea of the radical nature of this approach, Texas Teachers has **historically only put about 5% of its assets in hedge funds, private equity and real estate combined.** This is less than half of the average pension fund.

The Wall Street Journal reports that other big pension funds are content to sit back to see how the Teacher Retirement System of Texas fares with this new approach. If Harris is successful, the *Journal* says "**the result could shake up the $1 trillion pension-fund industry by helping to accelerate the trend toward hedge funds and other alternative assets.**" Of course, if the Texas Teachers fund does poorly, it will stigmatize these investments.

Who is this guy, Harris? His credentials are impressive. He came to the Teachers job from his post as **CEO of Bridgewater Associates**, a hedge fund group with about $165 billion under management. He also has been **head of Verizon's $70 billion pension fund.** He was born in Bryan, Texas and earned a degree in finance from TexasA&M, where he now teaches a course.

The *Journal* calls Harris's plan for the Texas Teachers Fund "**one of the largest-ever pension-fund wagers on investments like these.**" If it works, it can change an industry. If it doesn't, Harris told the *Journal*: "I'll go somewhere else." The teachers, however, will still be here.

Speaking of subprime mortgages, despite all the horror stories, one Texas real estate expert is suggesting they have served a purpose. And he has the stats to back up his contention.

Essentially, subprime loans replaced government loans for many low-income, first-time buyers. Since 1998, FHA and VA loans have declined from 30% to less than 10% of the residential market while subprime loans have increased from less than 2% to more than 14% of the total market, according **James P. Gaines**, a research economist with the Real Estate Center at TexasA&M. These higher risk mortgage instruments are estimated to make up **25% or more of all mortgage loans originated since 2001**.

Subprime mortgages are designed for low-income households with low credit scores and feature higher loan-to-value loans with significant prepayment penalties. Many of them carry adjustable interest rates, which means monthly payments increase as interest rates rise.

By their very definition, subprime mortgages are high risk. Inevitably, market realities catch up and these high-risk mortgages fail at considerably greater rates than moderate or low-risk investments. The increased delinquency and foreclosure rates reflect this reality.

When Gaines examined the figures, he found there have been a total of about 12 million subprime loans. If the foreclosure rate climbs above the current level to, say, 10% or 15%, this would mean up to **1.8 million loans will be vulnerable to foreclosure**.

While this is a lot, Gaines is quick to point out that "even at those high rates, **between 10.2 million and 11.3 million loans *would not* be foreclosed**, and those homeowners would continue living in the homes they might never have been able to purchase if not for subprime loans."

Gaines acknowledged the system is not perfect. "**Residential lending practices during the past five years ventured beyond merely aggressive into predatory and illegal**," and that "numerous lawsuits have been filed and more are expected against companies accused of predatory lending, fraud and misrepresentation."

This of course has been the focus of much of the negative media attention. And Gaines said the **illegal practices employed by unscrupulous lenders may not be easy to stop**, because the practices are "hard to clearly categorize as proper or improper, much less legal versus illegal."

Still, he is optimistic. "Given time, and with better informed homebuyers, **the market will correct the excesses and illegal practices under so much scrutiny today**," he predicted. And then, he said, this "should open the door for new programs to expand homeownership to millions of people in the future."

The face of retail in Austin is changing, if only because so many retail outlets are under construction or newly-opened. But bigger changes are on the horizon nationally that will also impact the Austin area.

Macy's likely sale to a private equity group is the start of the kind of realignment that has hit so many other industry sectors in recent years, forecasts our friends, *The Kiplinger Washington Editors*. **This could mean the end of some familiar names plastered on the sides of retail outlets all around the Austin area.**

> "Too many outlets, from department stores to specialty shops, are trying to sell similar merchandise to the dwindling number of people who don't shop at Target or Wal-Mart. Retailers such as **JCPenney, Belk, Dillard's and Kohl's are in the crosshairs of private equity groups**, which buy up firms and consolidate or close operations to boost profits," *Kiplinger* reports.
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> "Also likely: A winnowing of consumer electronic stores … **there's no way Best Buy, Circuit City and RadioShack can all survive**," *Kiplinger* predicts. "**Ditto for office suppliers Staples, OfficeMax and Office Depot**."

Sluggish retail sales are expected to grow only 3% this year, compared to 4% in 2006. Niche apparel stores are expected to only gain 1%. **The exception**: "**Luxury stores, where sales will rise 7% or more**," predicts *Kiplinger*. "Their wealthier clientele are racking up the biggest stock market gains and don't have to worry about rising gas prices or falling home values."

In the Austin area for now, **major retailers are bullish on the growth potential throughout Central Texas**. But many of those same national retailers may soon be changing the way they do business, if they continue to exist. Those changes will be felt in the metro area.

Dr. Louis Overholster says the best part about your grandkids coming to visit is that the minute they come through the door – you realize you haven't lost your hearing!

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Sincerely

Neal Spelce

Editor/Publisher