Stephen Monzione defaulted on his mortgage, but investors managed to profit on a security that contained the loan. **REUTERS/JESSICA RINALDI**

The Fed's 'quantitative easing' policy is giving rise to some mini-bubbles that are mainly benefitting well-to-do investors.

A subprime bond leaves behind a subprime borrower

BY CARRICK MOLLENKAMP

WOLFEBORO, NEW HAMPSHIRE, MAY 7, 2013

During the crazy days of the housing bubble in 2006, bankers created a bond called MABS 2006-FRE1. The instrument gave buyers the right to payments on the subprime housing loans of nearly 2,000 borrowers, including Stephen Monzione, a professional wedding photographer in New Hampshire.

Six months after the security was issued, a trader called it a "crap bond." Monzione, with a monthly income of about $900 and mortgage payments of $927.22, eventually stopped paying. So did hundreds of other people. The bank that originated the loans went bust. The bond's value crashed to 16 cents on the dollar.

Today, the subprime bond is rising from the ashes. The subprime borrower isn't.

A hedge fund manager in Colorado snapped up MABS 2006-FRE1 last summer and more than doubled his money in four months, thanks to a surge of investment into financial markets by the Federal Reserve.

The U.S. central bank hasn't been as helpful to Monzione. The 60-year-old lost a foreclosure battle and must be out of his home by the end of July.

"God bless them," Monzione marvels at the traders who flipped the bond of which his loan was a part. "I don't have a clue about what the hell that means to me personally."

Monzione has put his finger on a strange disconnect. Some 57 percent of borrowers' loans in MABS 2006-FRE1 are delinquent by 60 days or more, but the bond came roaring back nevertheless. Curiously, its recovery had little to do with the real-world fates of the individuals behind the bond.

The seeming paradox is one of the consequences of the Federal Reserve's policy of "quantitative easing" – an attempt by the U.S. central bank to help spur the economy by buying assets to generate huge volumes of cheap credit. The Fed campaign has been under way since the crash of last decade's housing bubble – which itself was inflated by a prolonged period of easy money meant to alleviate an earlier crash, the stock swoon of 2001.

The Fed's current program is indeed helping matters greatly, by shoring up banks and lowering the borrowing costs of corporations and home buyers who have good credit. But it is also giving rise to unintended consequences: new asset bubbles that are mostly benefitting well-heeled investors.

"FUNDAMENTAL DETACHMENT"

Under the third and latest round of its stimulus, nicknamed QE3 by traders, the Fed each month is buying $40 billion worth of high-quality mortgage securities (and $45 billion of longer-term Treasury securities). The idea is partly to drive interest rates lower on home loans, and partly to prod investors into other kinds of risk-taking activity that can create growth. Home loans are indeed cheap and sales are firming up in much of the United States.

But the Fed is also encouraging speculative fevers. Its massive purchases of mortgage securities have driven prices so high, and yields so low, that investors have scampered into riskier securities – like the MABS 2006-FRE1 bond. Thanks in part to the Fed's bond buying, the value of subprime bonds – a $300 billion market – jumped 21 percent between last spring and this March, according to Amherst Securities.

Fed Chairman Ben Bernanke's overarching goal in playing the bond markets has been to stabilize the financial system and maximize employment. He has tripled the central bank's asset holdings since the peak of the financial crisis in September 2008. The Fed said last week that it would increase the purchases if

Text continues on page 4

A fortune amid misfortunes

March 2006
MASTR Asset Backed Securities Trust 2006-FRE1 is sold to investors. It is a pool of loans originated by Fremont Investment & Loan.

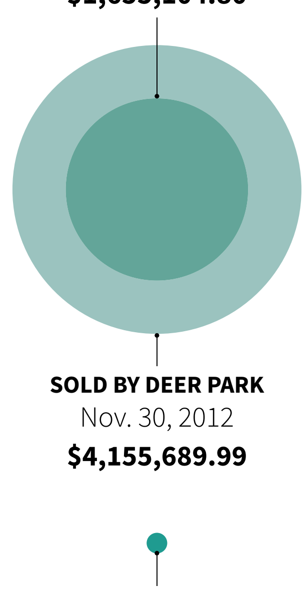
September 2006
Wall Street email describes MABS 2006-FRE1 as "crap"

March 2007
FDIC issues cease and desist against Fremont as the financial crisis begins

Aug. 3, 2012
Deer Park purchases the M-1 layer for 15.75 cents on the dollar

Nov. 30, 2012
Deer Park sells it for 39.12 on the dollar

PURCHASED BY DEER PARK
Aug. 3, 2012
$1,655,104.80



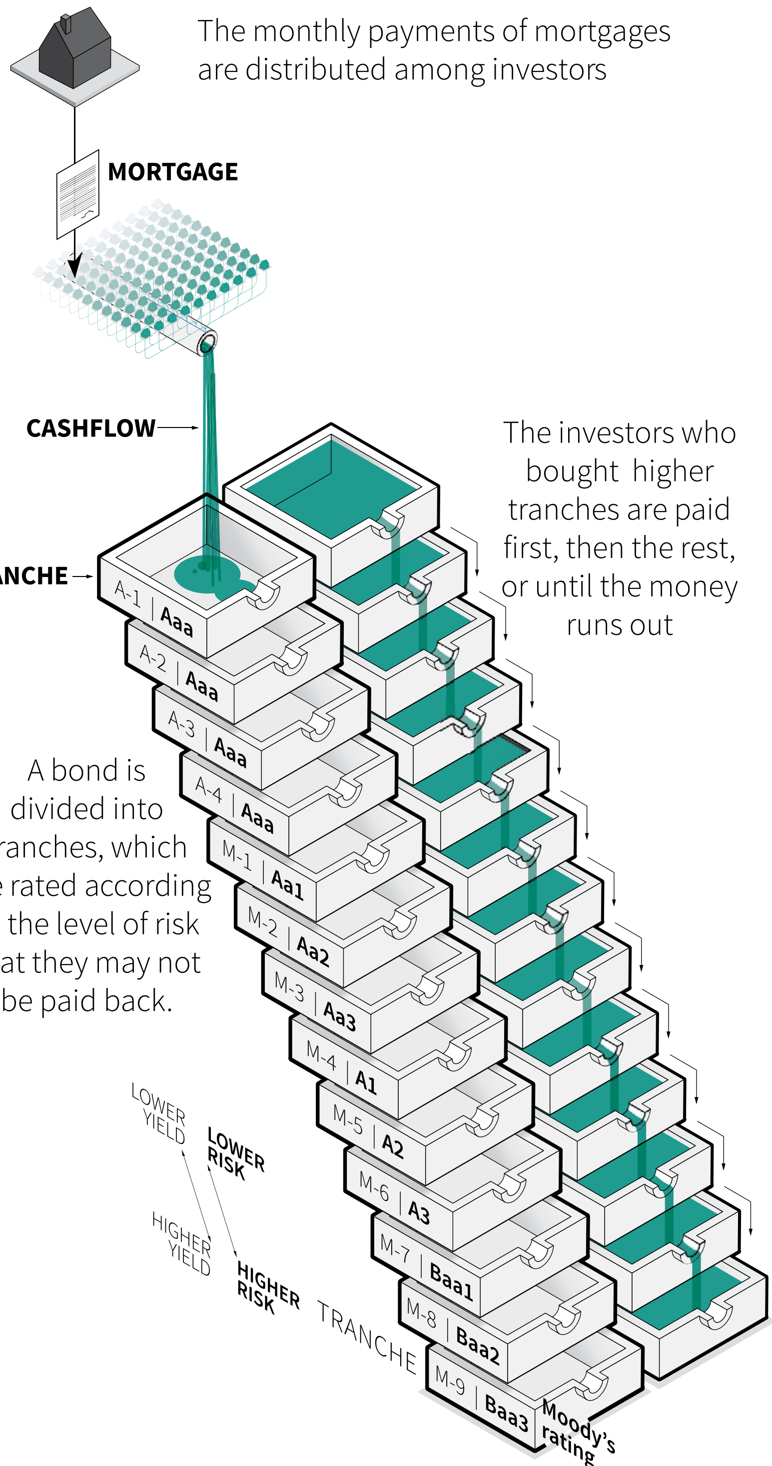
SOLD BY DEER PARK
Nov. 30, 2012
$4,155,689.99

CASH PAYMENTS TO DEER PARK
Aug.–Nov. 2012
$21,239.48

The anatomy of a subprime security

HOW A MORTGAGE-BACKED SECURITY WORKS

The monthly payments of mortgages are distributed among investors

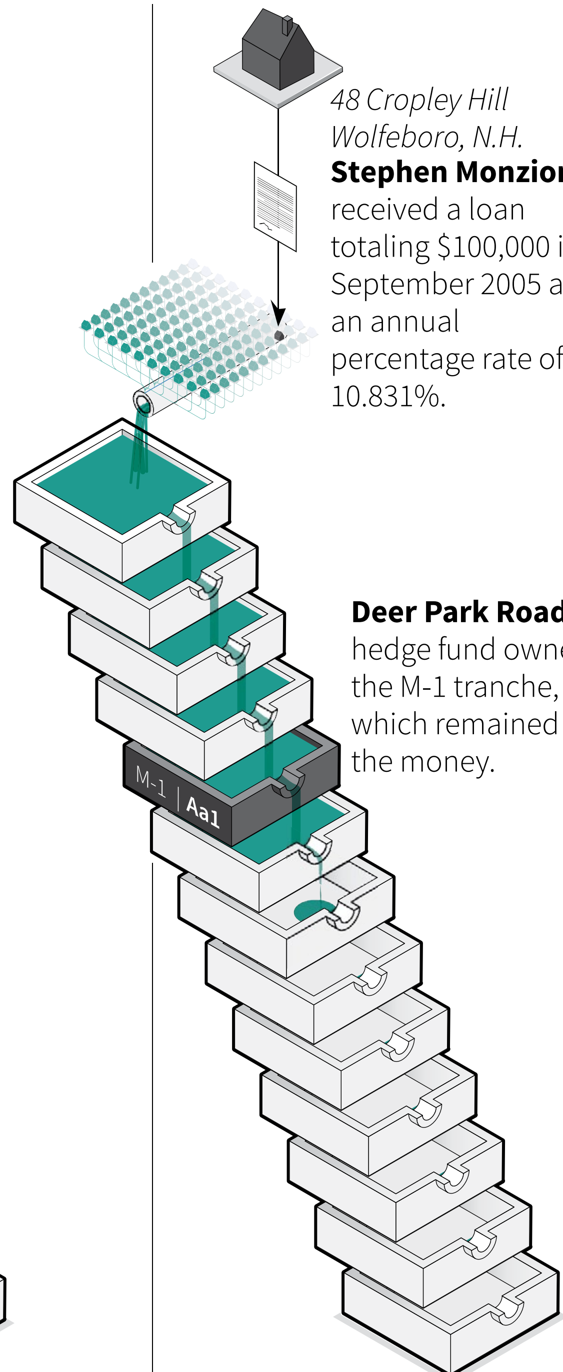


The investors who bought higher tranches are paid first, then the rest, or until the money runs out

A bond is divided into tranches, which are rated according to the level of risk that they may not be paid back.

Reuters graphic: Maryanne Murray

MABS 2006-FRE1



48 Cropley Hill Wolfeboro, N.H.
Stephen Monzione received a loan totaling $100,000 in September 2005 at an annual percentage rate of 10.831%.

Deer Park Road hedge fund owned the M-1 tranche, which remained in the money.

Source: Reuters

needed to shore up the economy.

Quantitative easing, however, is a blunt instrument that can do little to directly help people at the bottom of the economy. Such aid is easier to deliver through fiscal policy and legislative relief – for instance, jobless benefits or debt-reduction programs. But as the Fed has been stepping up its stimulus, federal and state governments have been cutting spending. Corporations have been hesitant to invest and hire.

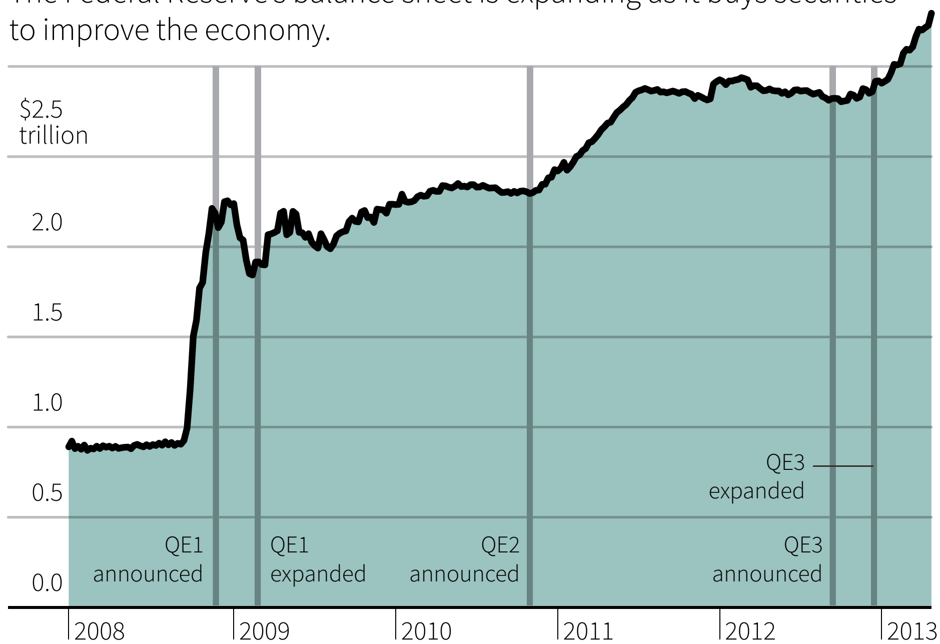
As a result, the recovery is spotty. The unemployment rate in April was 7.5 percent, the Labor Department said Friday. That's down from a high of 10 percent in 2009, but the number of people with jobs still hasn't recovered to pre-crisis levels.

"It's what we call a fundamental detachment," said Anthony Sanders, professor of real-estate finance at George Mason University. "The Fed is quite good at generating asset bubbles—just not the kind we want in the economy."

A Fed spokesman declined to comment.

Ben's big bet

The Federal Reserve's balance sheet is expanding as it buys securities to improve the economy.



Source: Federal Reserve

A DOOMED LOAN

Wolfeboro, where Monzione lives, is a summer resort town on Lake Winnipesaukee. A home called Lakeside Manor, where former French President Nicolas Sarkozy stayed in 2007, is listed for sale at $13.6 million. Mitt Romney, last year's Republican presidential candidate, has a home by the lake, too. During the campaign, he made pancakes there for a TV news show.

Monzione's house is a converted barn in the less desirable middle of the town, a few blocks from the lake. He wouldn't have been able to buy the place were it not for last decade's housing boom and an inheritance from his parents in 2005. He had his share of troubles before that, some self-inflicted, including divorce, bankruptcy and a drug addiction. (He says he went clean in April 1996.)

In 2005, when he decided to buy a house, his credit score was 532. A score of 640 or less is considered subprime. Still, Monzione wasn't among the many Americans who put no equity into his house. He did just the opposite.

The property, a "real fixer-upper," cost $130,000. A mortgage broker arranged for Monzione to get a $100,000 loan from Fremont Investment & Loan, based in Brea, California. He used $30,000 from his inheritance for a down payment, and made another $30,000 in repairs.

"I thought this is where I was going to stay forever," he said.

He figured the income from his wedding and studio photography business and a disability payment would cover the monthly mortgage bill. But he ignored the fine print. The mortgage had an adjustable rate, which meant payments would rise, stair-step, from $754.79 to $894.90 to a peak of $927.22 over the ensuing three years.

Ailments requiring stomach and sinus surgeries ate into his finances. Meanwhile, the advent of digital cameras hurt business. To make up for lost income, he turned to scouring estate sales for antiques and housewares to sell on eBay. It wasn't enough. The mortgage largely ate up his income.

The housing market has been recovering in parts of the country, and many homeowners have been able to refinance their loans at low rates, a product of the Fed's stimulus. But as in much of America, the comeback is uneven in Carroll County, of which Wolfeboro is a part. The number of homes sold rose 18 percent in 2012, but median sale prices stayed flat at $180,000.

A BOND IS BORN

Monzione got his loan from a unit of Fremont General Corp. Of the financial institutions that imploded last decade after providing too many risky home loans, Fremont ranked as one of the worst. The company was the fifth-largest U.S. subprime lender, with $13 billion in assets and 3,500 employees in 2006, according to a 2011 U.S. Senate report on the financial crisis.

In 2007 and 2008, after being sanctioned by regulators for aggressive lending, Fremont General filed for bankruptcy protection.

Well before that, in February 2006, Monzione's mortgage was bundled with 1,924 others that Fremont had originated, valued at a total of $472 million, according to a securities filing. They were packaged into the bond formally called MASTR Asset Backed Securities Trust 2006-FRE1, which UBS AG sold to investors. The Swiss bank declined to comment.

The deal was typical of the times. Subprime bonds worth hundreds of billions of dollars were created and sold between 2005 and 2007. In 2006, when MABS 2006-FRE1 was born, Wall Street sold $483.05 billion worth of such securities, according to Inside Mortgage Finance.

Securities such as MABS 2006-FRE1 were divided into layers, or tranches, based on risk and return. Revenues from the pool of home loans flow downward through the layers, waterfall-like. Buyers of the safer, top tranches get smaller payments than owners of lower layers, but they have first dibs on the stream of mortgage payments. Buyers at the bottom are paid more but are the first to suffer when borrowers stop paying.

The MABS 2006-FRE1 bond, which included Monzione's loan, had 14 tranches, according to securities filings and court documents.

Loans in the bond began souring almost from the start. That led a mortgage-bond trader at Deutsche Bank AG to tell a hedge fund in a September 2006 email that the security was a "crap bond," according to the 2011 Senate report. The email was one of a dozen or so cited by the report to illustrate how the German bank was advising clients whether to bet against poorly performing mortgage securities. Deutsche Bank declined to comment.

EXIT STRATEGY: Lawyer Paul Monzione negotiated a 'cash for keys' deal that pays brother Stephen to surrender his home to creditors. **REUTERS/JESSICA RINALDI**

> "Though only 12 months old, (MABS 2006-FRE1) is already shot full of holes.
>
> **Grant's Interest Rate Observer**
> February 2007

In February 2007, Grant's Interest Rate Observer, an influential Wall Street newsletter, cited the bond as a typical example of subprime bonds that were quickly souring and needed to be downgraded.

"Though only 12 months old, it is already shot full of holes," the newsletter said. Grants noted that 10.5% of the loans backing the security were delinquent as of January 2007, compared with 7.6 percent as of August 2006.

In May of 2007, Moody's downgraded three layers of the bond, blaming a "rapid rise in delinquencies in the past few months."

Five years later, in 2012, the bond caught the eye of a trader at a small hedge fund in Steamboat Springs, Colorado.

SKIING AND TRADING

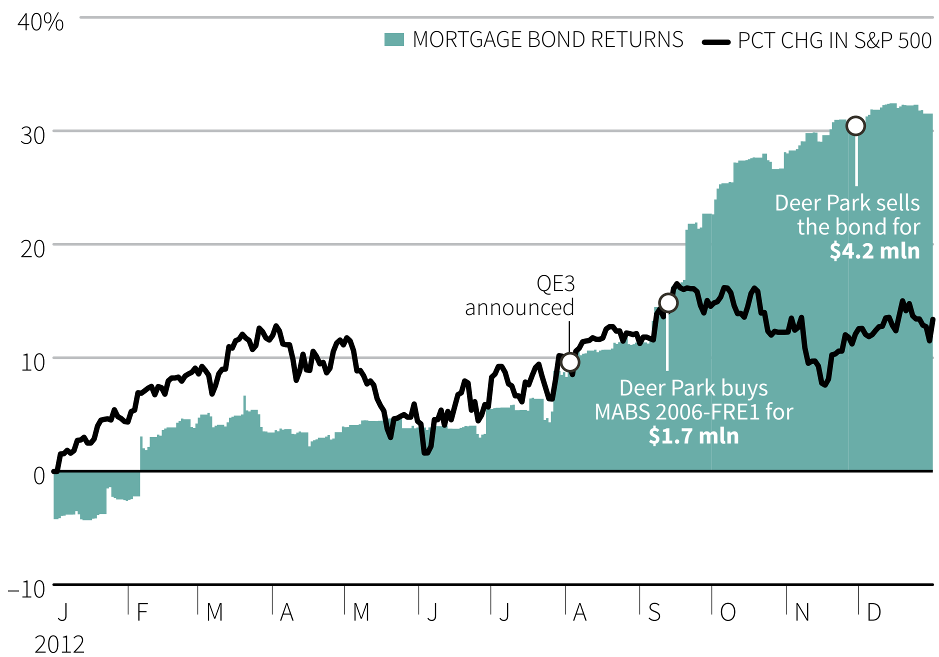
Deer Park Road has 14 employees who work in offices steps from the slopes of the Steamboat ski resort. Poles and skis hang from the walls. The only sign that it's a hedge fund operation are trading terminals. Its main offering is the STS Partners Fund.

Fund founder Michael Craig-Scheckman, 61, has an advanced physics degree from Columbia University. The native of Queens, New York, got his start in finance in the late 1970s, when cousin Asher Edelman – a 1980s corporate raider and partial model for Gordon Gekko in the movie "Wall Street"- introduced him to a firm that traded metals.

In the 1990s, as Monzione was trying to kick his drug habit, Craig-Scheckman was working at a hedge fund called Millennium

Sudden gains

Subprime mortgage bonds increased in value after the Fed's third-round of quantitative easing.



Sources: Markit; Thomson Reuters Datastream

Partners. There, he traded asset-backed securities – bundles of real-estate loans, credit-card debt or aircraft leases which then could be bundled into even more complex pools. By 2010, he was running Deer Park full time, where he hired Scott Burg, an expert in mortgage bonds.

They began assembling a portfolio that would lead to their banner 2012. The main goal: Hunt for beaten-down bonds that have loans yielding cash.

In August 2011, Deer Park bought a subprime security called Citigroup Mortgage Loan Trust 2006-SHL1. They paid 25.5 cents on the dollar for the bond at a cost of $1.2 million.

Last summer, Burg was searching for securities yielding 20 percent or more. A rally in mortgage bonds made the hunt a bit more difficult. "It did require us to turn over more rocks," the fund manager told clients in an investor letter.

On Aug. 3, Burg was pitched a potential deal by a small Florida broker. A middle piece of the MABS 2006-FRE1 bond, the broker said, was available for 15.75 cents on the dollar.

On the surface, the bond looked ugly. Some 57 percent of the loans underpinning it were 60 days or more delinquent.

But Burg liked the fact that the bond had some protection against losses: 27 percent of the loans would have to be valued as completely worthless, and the homes backing those loans would have to be worth zero, before Burg would lose a penny. Additionally, a further $300,000 in losses would have to emerge.

He calculated that enough borrowers were making payments to produce a steady stream of cash – some $5,000 a month, equal to about $60,000 annually on the $1.7 million purchase price for 21 years. "It had a very attractive profile," Burg recalled. He bought it.

Some of the most famous trades of the financial crisis involved investors, such as U.S. hedge fund manager John Paulson, betting on a fall in housing prices or a rise in defaults. Deer Park's play was different. It was attempting a simple act of bargain-hunting and would profit if housing rebounded.

"If homeowners do better, so do we," Craig-Scheckman said.

"FEROCIOUS"

Thanks to the Fed, however, Deer Park did well even as many homeowners didn't.

The Fed announced its third round of QE on Sept. 13, 2012. Prices of the subprime mortgage bonds held by Deer Park jumped in tandem with the Fed's target asset, mortgages guaranteed by government-sponsored enterprises Fannie Mae and Freddie Mac. Subprime paper, the supply of which had been falling as the underlying borrowers either repaid their loans or went bust, suddenly looked more attractive because of its much higher yields.

"I don't think anyone saw it coming," Burg, 34, said of the reaction. "I don't think anyone saw how ferocious it was."

Deer Park began finding buyers willing to pay top dollar. Six days after the Fed announced QE3, Burg sold the Citigroup bond for 39 cents on the dollar, or $1.8 million, a profit of 50 percent. By February, the value soared to about 65 cents on the dollar.

"This is one I wish we never sold," Burg said.

But other opportunities abounded. On Nov. 30, a broker in New York reached out to inquire about buying the MABS 2006-FRE1 bond on behalf of a client.

Burg negotiated briefly – about an

hour – before striking a deal at 11:08 a.m. Mountain time: $4.2 million for a security he'd paid $1.7 million for four months earlier. "Given the level that they were talking, there was too much of a profit to walk away from," Burg said.

Deer Park's fund ended the year up 27.43 percent. By comparison, the Standard & Poor's 500 Index's total return was 16 percent. As its holdings gained value and new client money flowed in, assets under management at Deer Park sextupled to nearly $1 billion this March from $148.5 million at the end of 2011.

Burg and Craig-Scheckman believe the rally in the subprime bond market can continue if the housing market improves. But they also are hunting for beaten-up securities linked to commercial property.

IN THE MONEY: Investors Scott Burg (left) and Michael Craig-Scheckman more than doubled their money on the bond that owned Monzione's loan. **REUTERS/KEN PROPER**

CASH FOR KEYS

In October 2008, as Craig-Scheckman was setting up Deer Park's main fund, Monzione was in deep trouble. The bank that acts as a trustee for MABS 2006-FRE1 investors initiated foreclosure on his home.

With the help of his brother Paul and sister Ann Marie, both lawyers, Monzione filed for bankruptcy. He then sued the bond trustee, alleging that Fremont had engaged in predatory lending.

But Monzione made a "lousy client," said Paul. At one point, Paul and Anne Marie told their brother to park $500 a month in escrow to build a pool of cash. That would have shown a history of payments to buttress his case, or provided a lump sum payment if he lost. Instead he bought more home wares from estate sales so he could sell them on eBay, hoping that he could persuade a judge to order a refinancing of his loan.

Paul tried to work out a new loan with the creditors. The problem, as many troubled borrowers have found amid the housing crisis, is that because the loan was included in a pool sold to investors, it was impossible to find one lender to negotiate with.

$1 billion

Deer Park's assets under management as of March

In January, a judge dismissed Monzione's last remaining claim. Monzione recently reached a "cash for keys" settlement in which he will be paid a sum of money in exchange for leaving the home. Paul declined to specify the amount.

Monzione is preparing to move out, rent an apartment and find storage for his figurines and antiques. The house remains cluttered with them. A porcelain Pinocchio doll recently was listed at $70.51 on his eBay page.

Asked how he felt that a bond containing his loan was such a bonanza for Deer Park, Monzione tried to be philosophical.

"That's amazing. And I mean, even after the fact that it's already crashed the entire United States economy," he said. "My paper is in there. It's not worth two cents."

Edited by Paritosh Bansal and Michael Williams

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