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THE BARKER PORTFOLIO

Don't Bet the House on This Insurer

Simple is good. And in investing, few strategies are simpler than seeking solid companies trading at low price-earnings ratios. Notable among them now is MGIC Investment, the nation's no. 1 underwriter of private mortgage insurance. Were you to buy a house without putting 20% down, chances are good that MGIC would insure the mortgage holder against default. Lately, MGIC sells for less than seven times estimates of 2003 earnings, down from a typical p-e of over 11.

Nice, but you can toss this simple strategy out the window if the earnings don't come in. That's the dreary outcome some short-sellers think is in store for mortgage insurers, especially industry leader MGIC, where they see two vulnerabilities. First, MGIC's profitability will erode if mortgage defaults keep climbing (chart). Second, it has a joint venture with one of its insurance rivals, Radian Group ([RDN](#)). Called Credit-Based Asset Servicing & Securitization, and unglamorously nicknamed "C-BASS," the venture will be hard put to boost profits as much as it did in 2002. Mortgage insurers have enjoyed years of prosperity and, as a bear suggested to me, "when it turns around, it'll be a shock."

To its credit, MGIC warned last summer of weaker conditions. The stock soon tumbled from over \$60 to its current level near \$40. Now, it makes no bones about the chance that this year's net, which it sees in the range of \$5.85 to \$6.10 a share, won't reach 2002's \$6.04. Yet MGIC does take issue with suggestions of anything awry at C-BASS, of which it and Radian each own 46%. A spokesman noted that MGIC's C-BASS stake, at \$169 million, is just 5% of book value. Adds Radian Chief Financial Officer C. Robert Quint: "It's just not that relevant" to either company's outlook.



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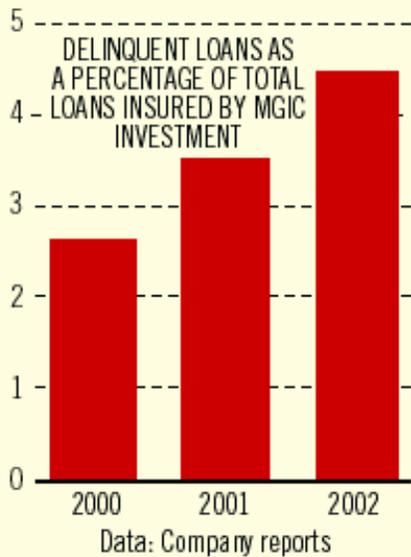
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Perhaps that's true for Radian, whose revenue sources are more diverse, including premiums from insurance on municipal bonds. But for MGIC, maybe not. Formed in 1996, C-BASS specializes in buying subprime mortgages. It then stays on top of borrowers to keep payments coming, while also bundling some mortgages for sale as bonds. Last year, business was terrific. C-BASS's contribution to MGIC's earnings per share grew by 16 cents, to 40 cents a share. That accounted for all and more of MGIC's 2002 profit growth. This year? MGIC sees the same contribution or a bit more. Radian is warier about C-BASS: "Last year was exceptional," Quint said. "To have a year as good as last year would be equally exceptional."

A key will be how well "credit-sensitive" mortgages perform if unemployment or interest rates rise. Getting a grip on how C-BASS might withstand more defaults isn't easy. "Virtually all of C-BASS's assets do not have readily ascertainable market values and, as a result, their value for financial statement purposes is estimated by the management of C-BASS," MGIC's financials note. "Adjustments could impact C-BASS's results." My translation: Trust us, C-BASS has correctly valued its portfolio of subprime loans; but if we're wrong, C-BASS's profits could fall.

A similar danger haunts MGIC's insurance biz. Hewing to accounting rules, MGIC sets aside reserves against claims only after mortgages actually go into default. MGIC thinks 2003 will bring enough defaults that reserves, \$733 million at yearend, will rise \$90 million, to \$110 million. If that estimate is too high, net could be better than expected. But if it's too low, watch out. Michael Sklarz, chief valuation officer at Fidelity National Information Solutions ([FNIS](#)), a real estate data provider, sees trouble ahead as home prices plateau: "Just a leveling out, not even an outright decline in housing prices, is associated with higher default and foreclosure rates."

The bears believe they've seen this show before. In the fall of 2000, credit-card issuer Provident Financial's ([PVN](#)) stock hit \$67. A year later, it fell to \$2 after the company reported steep losses on loans to consumers with weak credit. Shares of AmeriCredit ([ACF](#)), which focuses on low-quality auto loans, traded last spring near \$47. Today, they go for \$3, after the company found too many loans uncollectible. MGIC ([MTG](#)) might escape such trouble. But to me, that's no simple bet.

By Robert Barker

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