Toxic Assets: Don't Be Tempted to Buy These

The fund company BlackRock will launch a fund that invests in toxic assets like mortgage-backed securities. The following discusses the reasons to avoid the fund.

BlackRock Inc. recently announced it is launching a fund that invests in the toxic type of mortgage-backed securities (MBS) that nearly took down the credit markets over the past two years. The fund will be investing in these securities as part of the Public Private Investment Partnership (PPIP).

While it may be tempting to buy assets with high yields (especially during periods of low interest rates), remember that the main role of fixed income should be to provide stability and reduce overall volatility in a portfolio. Also it is important to remember to never confuse yield and returns. This fund will likely significantly increase the volatility and risk of a portfolio.

BlackRock will likely take large fees for its services, which means investors would not earn the return the market requires to buy these types of risky assets. The only winner would likely be BlackRock. Investors seeking higher returns are better served taking risks on the equity side of the portfolio and keeping the fixed income portion safe.

Also consider that this type of exposure is already found in many mutual funds through holdings of bank and financial company stocks. Federal officials announced on August 21 that Guaranty Financial Group's failure (the 10th largest bank failure in U.S. history) was caused primarily due to its holdings of toxic mortgages. Once thought of as safe investments, banks are now selling these toxic assets to get them off their books.

It is important to note that there is a distinction between MBS issued by private corporations versus MBS that are still AAA rated and backed by government-related entities such as FNMA and FHLMC. Nearly 1,400 banks own toxic MBS known as "private issuer" or "private label" mortgages, which were packaged by Wall Street firms and heavily marketed to investors. Small and regional banks own roughly $37 billion of these toxic assets and regulators are pressuring them to write down the value of these assets as more homeowners fall behind in their mortgage payments.

Summary

The lure of potential high returns from buying financially distressed securities at so-called cheap prices may be tempting for the brave of heart during times of uncertainty and low interest rates. However, we recommend avoiding toxic assets. The role of fixed income should not be to produce equity-like returns, but to provide stability to portfolios. Adding toxic assets to a portfolio exposes it to much greater volatility.

Sources

The following sources were used by the author(s) to arrive at the above conclusions.

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