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The Great American Heist

Fannie Mae Common Stock, $FNMA:
- $0.65 per share, current price
- 2024 Price Target of $44

Fannie Mae Preferred Shares T Class, $FNMAT:
- $2.95 per share, current price
- 2024 Price Target of $17.85

Introduction/FAQs

1. What does Fannie Mae do?
    a. Simplified, Fannie Mae helps provide a unique American service, the 30y mortgage. While Fannie does not originate mortgages, once a bank has originated one, they would sell it to Fannie Mae, and Fannie would then proceed to sell Mortgage-Backed Securities against the group of loans.
2. What is the FHFA?
    a. The FHFA stands for the Federal Home Finance Agency and became the administrator of Freddie and Fannie in 2008 when they entered under the conservatorship of the FHFA. The agency was created in 2008 in response to the financial crisis, primarily to administrate Fannie and Freddie.
3. What happened to Fannie Mae during the Financial Crisis?
    a. While Fannie Mae's loan portfolio did not fare that well during the crisis, it did not need to. The US Government took them over, soon after (truthfully) saying that Fannie was very well, and properly capitalized. Once Fannie was under Government conservatorship, they were forced to realize extraordinary losses. Without government intervention, Fannie Mae would have still done very well, due to the proper risk management policies in place before, during and after the crisis.
4. If Fannie was so well capitalized, then why did they take such extraordinary losses?
    a. Partially because once under conservatorship, it was in the government's interests to make Fannie appear much weaker than they were. However, once Fannie could bring the loan portfolio back to "fair value estimate" in 2012/2013, it led to one of the most profitable quarters for any company, in all of history. Not exactly a struggling company.
5. Why has it not been taken out of conservatorship yet then?
    a. It would be impossible to have a concrete answer for why this is, but I think it is due to a few factors.

b. Firstly, for close to a decade, the US Gov has been implementing a "Net Worth Sweep" which sends all profits from Fannie to the United States Treasury (UST). Until about 2016, much of these funds were going to pay back the ~$100b that the government gave Fannie in the GFC. After that, the funds had been paid back, and has just added towards the UST's profit. It was much harder to argue releasing Fannie until UST had truly been paid back. This Net Worth Sweep (NWS) was not halted until Trump's Secretary of Treasury, Steve Mnuchin. This halt enables Fannie to begin building the excess funds/shareholder's equity back up, one of the goals required before exiting conservatorship. With the start of the Biden administration, Biden's Secretary of Treasury, Janet Yellen, continued the halt, which is a crucial signal of the collaboration between the two.

c. Secondly, since 2016, there has not been a match between strong economic conditions for its release & the right people being motivated to do so. While former President Trump took note of Fannie's conservatorship in 2020, it would have been unwise to release them during the economic instability of the COVID-19 Pandemic & lockdowns. With President Biden, it appears as if he is in the starting stages of prepping Fannie for release from conservatorship.

The History of Housing Government Sponsored Enterprises (GSEs)

1930's

- 1932: Federal Home Loan Bank act is passed. Creates the FHLBank System
- 1933: Homeowner's Loan Act is passed, creating the Homeowners' Loan Corporation
- 1934: National Housing Act enacted, establishes Federal Housing Administration
- 1938: Fannie Mae Established

1940's

- 1944: GI Bill authorizes VA mortgage loans, and Fannie Mae's purchases of the loans

1950's

- 1954: Charter Act reorganizes Fannie Mae

1960's

- 1968: Fannie Mae reorganized as a publicly traded shareholder owned company
- 1968: Housing and Urban development Act of 1968 created Government National Mortgage Association, also known as Fannie Mae

1970's

- 1970: Freddie Mac created
- 1971: Freddie Mac offers its first conventional Mortgage-Backed Security.

1980's

- 1989: Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA") is passed to address the savings and loan crisis.
- 1989: Freddie Mac becomes a publicly traded shareholder owned company.

1990's

- 1992: Federal Housing Enterprises Financial Safety and Soundness Act enacted, creating the Office of Federal Housing Enterprise Oversight.
- 1995: HUD establishes new goals for Fannie Mae and Freddie Mac requiring them to meet an "affirmative obligation to facilitate the financing of affordable housing for low-income and moderate-income families"

2000's

- 2000's: Fannie Mae and Freddie Mac begin purchasing Alt-A and subprime mortgages
- 2006: Housing prices begin to fall nationwide for the first time since the 1930's
- 2008: Housing and Economic Recovery Act enacted, creating the FHFA.

Thesis

Fannie Mae and Freddie Mac were both unlawfully taken under government conservatorship by the United States Government during the Great Financial Crisis in 2008-09. They function best as non-government owned companies, in their special GSE (Government Sponsored Enterprise Structure) because it allows them to complete their goal most effectively through talent recruitment, long term goals, and financing the American Dream.

If they are to be taken out of conservatorship, it could lead to current common shareholders receiving the ownership stake in the company that they may already legally own. In this scenario, Fannie Mae would violently re-rate to the upside. Even if common shareholders are wiped out, preferred shareholders may be paid back the full par value of their shares in the restructuring, approximately 8x the current price. By balancing a 50/50 approach between common shares, and Pref shares, it enables one to invest in the best risk-adjusted fashion.

As I have outlined below, there are various scenarios for Fannie Mae which can play out, and differing timelines as well. Many of these could play out in the next 6mo to a year, decades, or never at all.

Scenarios

These will be ranging from “Worst Cast” to “Best Case” scenarios. The price targets should be assumed for end of year 2024.

*To convert the two numbers, (+2,900%) would equal a 30x return on investment

Total Wipeout
P= 30%
FNMA: $0 (-100%)
FNMAT: $0 (-100%)
This scenario involves all the share classes trending towards 0, being worthless. A complete wipeout could take years, or even decades to fully play out, but as time goes on, it would appear more and more likely.

Preferred Boarding
P= 20%
FNMA: $0 (-100%)
FNMAT: $25 (+747%)
For this scenario, only the Pref shares have any value (at par), and common shares are completely written down to $0 ea. This would be prevalent should the US Government announce that Fannie Mae will be going through restructuring. This has much of the legal & historical precent on its side (General Motors, Railroads, etc.) which is very beneficial.

Diluted Disaster
P= 10%
FNMA: $0.45 (-30%)
FNMAT: $25 (+747%)
For the Dilution scenario, it involves common shares being heavily diluted, but with Pref shares getting their par value back. This would be a mix of the US Government having their 80% stake in Fannie Mae, then heavily diluting the current common shares via restructuring, or raising capital so that Fannie Mae could be removed from conservatorship.

Warrant-ed Actions
P= 15%
FNMA: $20 (+2,976%)
FNMAT: $25 (+747%)
Here, the government brings Fannie Mae back into private hands, but executes the full warrants, so that 20% of the company is held by current stockholders, and the US Government owns the additional 80%. However, this involves no further dilution beyond that, and would be equivalent to a $100/share valuation ex-dilution.

American Dream
P= 10%
FNMA: $80 (+12,207%)
FNMAT: $25 (+747%)
For the "American Dream" scenario, it would involve some combination of the US Government having to pay damages to the shareholders, Fannie Mae's multiple changing (higher if full dilution, lower multiple assuming no dilution), or the equivalent change in underlying business fundamentals.

Golden Palace
P= 10%
FNMA: $180 (+27,592%)
FNMAT: $25 (+747%)
In the Golden Palace, it is the scenario where there is no dilution of shareholders, the 4th amendment of the PSPA is considered Illegal, and Fannie Mae can trade at a low double digit multiple.

Running of The Bulls
P= 5%
FNMA: $300 (+46,053%)
FNMAT: $32 (+984%)
For the Running of The Bulls, it would be the complete annulment of the PSPA 4th Amendment, which removes the dilution from the government, and current shareholders would own 100% of the Pro-Forma company. In addition, the $300 common share price target would require for damages to be paid, beyond the initial equity of the company. Damages would be included for the Pref shares as well.

Scenario Name	Common Shares Target Price	Preferred Shares Target Price	Strategic Allocation Total Return*
Total Wipeout	$0	$0	-100%
Preferred Boarding	$0	$25	+300%
Diluted Disaster	$0.45	$25	+350%
Warranted Actions	$20	$25	+2,540%
American Dream	$80	$25	+9,260%
Golden Palace	$180	$25	+20,560%
Running of The Bulls	$300	$32	+34,012%

*For the "Strategic Allocation" that seeks to target 50/50 common/preferred shares. Currently that means buying 7 $FNMA shares and 1 $FNMAT share. That is a total cost of $6.25.

Common Shares Valuation: $44

Scenario Name	Common Shares Target Price	Probability	Weighted Value
Total Wipeout	$0	30%	$0
Preferred Boarding	$0	20%	$0
Diluted Disaster	$0.45	10%	$0.045
Warranted Actions	$20	15%	$3
American Dream	$80	10%	$8
Golden Palace	$180	10%	$18
Running of The Bulls	$300	5%	$15
SUM/TOTAL	$44		

Pref Shares Valuation: $17.85

Scenario Name	Preferred Shares Target Price	Probability	Weighted Value
Total Wipeout	$0	30%	$0
Preferred Boarding	$25	20%	$5
Diluted Disaster	$25	10%	$2.5
Warranted Actions	$25	15%	$3.75
American Dream	$25	10%	$2.5
Golden Palace	$25	10%	$2.5
Running of The Bulls	$32	5%	$1.6
SUM/TOTAL	$17.85		

Risks

I hope that it has become clear at this point that while I believe in the thesis, there are severe risks for this investment. Several of which I discuss below, but there could be further that are unforeseen.

Timeline

The timing is a clear risk from the very start, as while there are various court cases and catalysts for the next few years, the Fannie Mae controversy could continue for much longer. For example, there have been many investors who invested soon after the GFC but have been waiting close to 14 years for something to happen towards moving out of conservatorship. The timing risk should not be ignored by an investor, and it is important to stay updated on any catalysts. It is important for investors to adjust using a discount rate/required return to adjust for this.

Dilution

As it is a key variable in the different scenarios, how much dilution and at what price it happens at, could very well have a massive impact on the fair value for Fannie Mae. The PSPA that Fannie was forced to sign by the US Gov exposes them to significant dilution via the warrants, which is the clearest factor from this risk.

Mortgage & Economic Downturn

Should the Mortgage market face a severe recession or implosion, it could be a strong negative for Fannie's intermediate term financials. While I believe that in the long term Fannie's risk management prevents and long term damages to the business, should the fundamentals and multiples suffer, then so would the corresponding stock price & fair value. In fact, many of the risk management policies have only gotten tighter/stronger since 08-09, which means that unless a recession is many magnitudes worse than the GFC, and prevails for much longer, Fannie Mae should be in a very strong position over the long run.

Main Legal Arguments

1. The United States Government violated the "Takings Clause" of the US Constitution's 5th Amendment through the Net Worth Sweep and illegal conservatorship. The clause states, "Nor shall private property be taken for public use, without just compensation" and it can be argued that with Fannie Mae the property, Fannie Mae stock and earnings, were taken illegally to be used for the public and US Treasury, but without paying the Fannie Mae shareholders anything. Thus, Fannie Mae's history may have broken that clause, and the shareholders will be rewarded at fair value.
2. Secondly, the US Constitution states that an independent agency, like the FHFA (Federal Housing Finance Agency) and that an agency like the FHFA cannot be headed by a single director. Nor can that director be fired by the President, at will. Which would mean that the structure of the FHFA when Fannie entered conservatorship was illegal, and FHFA

never had authority, meaning that Fannie Mae & Freddie Mac would have to be released from conservatorship.

Freddie vs. Fannie

Due to the vast similarities between Fannie Mae (FNMA) and Freddie Mac, much of the analysis for one applies to the other. Particularly due to them both undergoing the same conservatorship, the catalysts for one, should work for the other. I would recommend doing your own analysis on Freddie vs. Fannie to see which could yield better returns, based on the stock prices at the time.

I focused on Fannie Mae because it is regarded as the “older sibling” to Freddie, as a larger company working with larger financial institutions. That may in theory provide more security to the business model.

Conclusion

I believe that Fannie Mae provides a once in a century risk to reward due to such high upside, and legal precedent defending the preferred shares, which in theory limits the downside. With the mixed strategy of Preferred Shares & Common Shares, it should provide significant upside (up to 340x with the Commons) but is able to succeed in various restructuring scenarios because of the Preferred shares.

Should the thesis of exiting conservatorship play out, I also think that holding the actual Fannie Mae stock after the stock price is closer to fair value, is a harder decision, but should be left up to the individual investor, institution, or group. For example, should the reward be reaped through $FNMA having full rights to the Fannie Mae equity and net income, instead of a settlement check, then the end value depends heavily on the recent Net Income of Fannie Mae at the time.