**95/05-Bet the Houses**

**Fannie Mae is misunderstood, underappreciated, and undervalued. But don't pity this company. Buy it.**

**By Peter Lynch**

In the stock market, no less than in police work, there are cases of mistaken identity. Once in a while, a reliable company with a steady source of income gets stuck in the line-up with the known gamblers, companies that are in cyclical industries and therefore have unpredictable incomes. Being thrown in with the gamblers can have a depressing effect on the stock price.

One of my favorite victims of mistaken identity is Fannie Mae (NYSE: FNM), formally known as the Federal National Mortgage Association. I've recommended the stock for a decade and owned it all along, and I'm still recommending it even though the price has risen from the single digits into the $70s. That's because it's still cheaper than it would be if Fannie Mae were correctly understood. For ten years, it's been a reliable earner that can't shake the image of being unreliable, so the stock sells at a low multiple to earnings

Through seven years and one recession, Fannie Mae has turned in 28 consecutive quarters of record earnings. If you covered up the name on the chart and asked the nearest Wall Street analyst what company produced these results, he'd probably say Wal-Mart or Home Depot. The difference is that Wal-Mart's stock is priced at 17 times earnings in today's market, whereas Fannie Mae is priced at 9 times earnings. It's a $75 stock that could easily become a $100 stock, overnight, if Fannie Mae started using an alias.

Fannie Mae is a former government agency that was privatized and first sold its stock to the public in 1968. It's the world's foremost owner and handler of mortgages. It buys them by the thousands, then bundles them into packages. Thanks to FannieMae and its close relation, Freddie Mac (the Federal Home Loan Mortgage Corp.), mortgages have become a commodity like barrelsof oil or bushels of wheat. Banks and S&Ls; no longer hold onto mortgages the way they once did. They sell them to FannieMae to be packaged, then use the proceeds to make more loans.The result is that mortgages are easier to get, and you and I pay cheaper rates. When banks or S&Ls; want to own mortgages,they simply buy one of the packages. There's a very active market for these so-called mortgage- backed securities.

Fannie Mae has been a great success as a private enterprise. It pays $1 billion in taxes annually, whereas if it were still part of the government, like the Federal Housing Administration, it would be sopping up taxes. The FHA is also in the mortgage business, but Fannie Mae with its 3,500 employees does twice the volume of the FHA with its 5,400 employees. It makes you root for the FHA to be privatized, along with the post office.Imagine the post office run by Fannie Mae, delivering the mailat peak efficiency and sending $1 billion a year back to the Treasury.

The reason Fannie Mae gets lumped in with the unreliable earnersis that it used to be one. The old Fannie Mae was more like GM or Chrysler: rags to riches and back again. It borrowed moneyat short-term rates and invested in mortgages that paid long-termrates. This worked fine as long as short-term rates were lowand long-term rates were high as long as the yield curve wasnormal, in other words. But when short-term rates went up, FannieMae would bleed red ink. At one point, it was borrowing moneyat rates that varied from 12 to 16 percent while holding mortgages yielding 7 to 11 percent.

In the early 1980s, Fannie Mae changed its strategy. The average mortgage lasts about seven years, so Fannie Mae decided to pay for its mortgages by selling bonds of an equivalent maturity. If it could earn, say, 10 percent on a mortgage and pay 9 percent interest on the bonds, it would lock in a 1 percent profit for the seven years

Now Fannie Mae was borrowing long and lending long. This was more expensive than borrowing short, but it removed the risk of rising rates. Fannie Mae also removed the risk of falling rates by making its bonds callable, which means it can redeemthe bonds at will. So when millions of homeowners refinance their mortgages at lower rates, as they did in 1992, 1993, and 1994. Fannie Mae can refinance its bonds at lower rates and maintain its spread.

It other words, Fannie Mae is no longer interest-rate sensitive. By borrowing long and issuing callable debt, it has lessened its earnings in the short run and given up the chance of making the occasional killing when interest rates go its way. But it has proved it can make a steady profit on rising rates, as in1994; falling rates, as in 1993; and recessions, as in 1990–91.This is the kind of company that Wall Street loves to own: a10 to 15 percent grower that's reliable. Yet a lot of people can't seem to stop worrying about Fannie Mae long enough to appreciateit. Interest rates go up, they sell the stock. Interest rates go down, they sell the stock. Saddam invades Kuwait, they sellthe stock. The dollar falls, they sell the stock.

There's no such thing as a worry-free investment. The trickis to separate the valid worries from the idle worries, and then check the worries against the facts. Since Fannie Mae has reinvented itself, the facts have been easy enough to check.

Remember the headlines six years ago, when people were worried about the collapse in real estate? A big drop in housing prices would seem to be a disaster for Fannie Mae, which owns billions of dollars' worth of mortgages. As it turned out, the prices of fat-cat houses were declining, but the prices of the vast majority of modest houses held up. In fact, the median priceof a house has been on the rise for 27 years, ever since the statistic was first published. It comes out every month. So all you had to know was that Fannie Mae didn't have anything to do with fat-cat houses, and that its average mortgage was $80,000, and you would have ignored the dire predictions and held on to the stock.

Five years ago, people were worried about the recession and how millions of workers would lose their jobs and default on their mortgages. In the oil-patch recession of the mid-1980s, thousands of homeowners walked away from their loans and sent the keys back to the bank. This hurt Fannie Mae, but it learned its lesson and tightened its credit standards. Throughout the1990 recession, when 2 million people did lose their jobs and banks such as Citicorp were reporting delinquency rates of 3 percent or more, Fannie Mae's delinquency rate was negligible less than 1 percent. The company passed the recession test. Today,its delinquency rate has fallen to 0.57 percent, an all-time low. The company publishes this data every quarter, so you and I can keep track of it.

By the end of the recession, people were worrying that the babyboom was over and that soon we'd have fewer people buying houses and taking out mortgages. But halfway into the 1990s, we've hadthe highest population growth since the 1950s and the highest immigration levels since 1910. Even if we did enter a period of zero growth in the housing market, the mortgage market could still grow. That's because of all the older homeowners in this country who paid off their mortgages long ago. When they sell their houses to move into condos or the Great Beyond, the buyers of those houses will be looking for mortgage loans.

Fannie Mae and Freddie Mac (I'm a shareholder in Freddie Mac,too, and I recommend it) already control 40 percent of the U.S.mortgage market, either as owners or as packagers. Mortgage-backed securities didn't exist 25 years ago, when Freddie Mac invented the idea and Fannie Mae followed. Today, this is a trillion-dollar business, most of it divided between Fannie and Freddie. Year by year, the two pioneers are capturing an ever-greater share of all mortgages.

The latest worry is that the government will meddle in FannieMae's affairs by imposing fees and restrictions, or by taking away some of its business the way it has with Sallie Mae (the Student Loan Marketing Association). But that's not likely to happen. In 1992, Congress passed a law that set higher standardsfor Fannie Mae and Freddie Mac and required them to strengthen their capital reserves. They've done so and today are the mainstays of our housing-finance system.

As I write this, Fannie Mae is sitting on $40 billion of surplus cash, half of which could be invested in mortgages. The old FannieMae would have put that money into mortgages right away, to boost profits immediately. The reformed Fannie Mae is holding back,waiting to lock into a better spread. This strategy has put adrag on earnings growth, which is why a lot of big-time investors and the so-called momentum players have been avoiding the stock. Once Fannie Mae puts this chunk of money to work, the growth rate will pick up again. Either way, the company will show its usual steady progress.

In June, investors will descend on Washington to hear FannieMae give what promises to be a favorable progress report. Eighty-five percent of the shares are owned by institutions, many of which will be there to get the good news in person. Average investors who do their homework in advance have a chance to get a jump on the herd.

I never believed in the efficient-market theory, which says that all the information about any company is reflected in the current price and that therefore the price is always rational.Fannie Mae, stuck in the lineup with the cyclicals and sellingfor a price-to-earnings ratio of 9, is all the proof I need that the market makes mistakes.