Market wisdom INVESTOR EMPOWERMENT SERIES

LESSON NO. 33 FROM THE HOUSE OF ASIT C. MEHTA INVESTMENTS

Subprime Mess

We are now part of a global economy. In the short run issues, which affect the world markets also, affect us, though there may not be a direct co-relation to the extent of impact. One such issue that is currently affecting all of us is sub-prime crisis in United States. This is a new word in our financial dictionary. The meaning is simple, that which is not prime is sub-prime. Prime word is used in relation to rate of interest. Lending at a prime rate is done for those borrowers who meet certain safety criteria. There is a guarantee that borrower will payback principal as well as the interest. The lending is against an asset, which is also saleable easily and can be liquidated into money if there is a default.

To make it simpler for understanding in Indian context, it is like borrowing from the bank which is at a lower rate say 12% pa and borrowing from a Marwadi money lender who is ready to lend to you at any time, without any paper work and that too on assets against which bank will never finance, but the rate of interest which is 24 %. This high interest is for the risk of default. Now if the banks or finance companies start lending like the marwadi on high interest rates, against assets, which are not easily saleable then, you can imagine the crisis when the borrowers fail to pay and the depositors who have given money to the bankers as depositors want their money back.

Post 9th September 2001 i.e. the World Trade Center attack; there was fear of recession in US economy. The rates of interest, which were in the range of 7%, were brought down to 4.75 %for sometime and further to 1% in a short span of time. This was done to lower the cost of production so that various goods and services become cheaper and people buy more. Though the goods become cheaper, the money that was not spent i.e. saved started earning lesser and lesser return. However, if the money was used as margin money for loans to buy assets such as property there were large numbers of tax sops available against installment and interest payment. Hence, the entire mind set of the citizens moved from saving to taking loans for purchase of assets be it property or shares or commodities. This led to over leveraging i.e. citizens borrowing more than their capacity to service the debt.

The activity got a further boost when all the participants in the financial system wholeheartedly started selling this concept. There were enough financial brokers who marketed these loans. These loans were securitized i.e. The loan portfolio was further converted into a loan (debt security) and sold off to another investor who was willing to lend. This parcel contained good and bad loans therefore the percentage of prime and sub-prime could be varied and different packages of loans could be sold. Rating companies also gave investment grades to such loans so that it facilitates securitisation and marketability. More money flowed in since the rates of interest were much higher compared to other investment options. After securitization these loans could then be sold in small parcels in the market so that large number of participants could be attracted in the market. These parcels were called CDO's (Collateralized Debt Obligation). Hence loan business, which was restricted to a handful of bankers, or finance companies became everybody's business.

The lenders expected that the property prices were likely to increase due to the huge demand as a result of free flowing loans to a large number of borrowers. In the event of default, property could always be sold off and money realized. As the defaults started there was seizure of assets and the politicians got the wind of it. It was a good opportunity for the politicians. Politicians started protesting since citizens who could not pay were being made homeless. The television publicity that was given to this event put the entire country's financial system on alert.

Genuine demand for homes was put on hold since citizens expected property prices to come down due to huge supply of houses in the market as a result of payment defaults. The lenders for home finance also became wary since they were afraid of defaults hence free flowing money was largely curtailed. Short term money was generated due to sale of CDO, which was invested in long term loans. This mismatch created a crisis, since the short term lenders demanded their money back and the inability to recover the loans on overnight basis led to many fund managers, such as BNP Paribas and Bear Stearns & Co to stop withdrawal of money.

This financial crisis spread to stock market also. There was lot of free flowing money in the stock markets as a result of large scale leveraging. There was also fear of economic slow down since people who buy houses also buy lot of white good such as televisions, refrigerators ovens etc. This would lead to fall in demand for many companies, which thrive, on household sector. There was a steep fall in share prices in US markets followed by fall in share prices in Asian markets. India could not be left behind; we also had a more than1000 point fall.

The fall of share prices in India was due to two reasons. The first being dominance of Foreign Institutional Investors (FII) who were expected to pull out money from India since they had to pay back obligations of their US investors. The second reason was Private Equity money , which is made available to Indian companies. This money flow would slow down if the private equity funds did not manage to collect the money that was promised by investors in US and other foreign countries.

Indian markets have corrected since this was a crisis that did not affect directly. The US finance markets and their bankers have made money available to pay those investors who panicked with the unfolding of events. Is the problem over? We do not know since close of US $ 100 of sub-prime debt is part of $ 375 billion debt in US. Each time there is news of default the markets react and following US markets the Asian markets react followed by India.

Only advice we can give to investors to keep vigil on international events as this kind of problems will surface off and on in the near future. Let us remember, our economic fundamentals have not changed, they continue to be bullish. Advance tax collections are on the rise and GDP growth of 8% +. If you are not in the market use theses falls as an opportunity to buy. Traders will lose money since these falls can be sharp, unexplainable and sudden. Sometimes our markets may react to other markets, whereas sometime they may not. Long term investors should treat this volatility as an opportunity.

Exciting times are ahead for investors but nightmares for traders.

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SEBI / Regulatory Registration Numbers :
• BSE C.M. : INB 010607233
• NSE C.M. : INB 230607239
• DP Registration (C.M & Derivatives) : IN - DP - CDSL - 28 – 29

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