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Top Stories

'Time will tell' if all the sub-prime bad news has been priced into the market

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Chennai, Aug. 11: Market watchers who have been witness to the sub-prime shocks playing out during the week wonder, 'Is this the end?' Has all the bad news been priced into the market? Is there now a buying opportunity? Or, are there more disasters to come? Bear Stearns, Highbridge Statistical Market Neutral Fund, BNP Paribas… is anyone next?

These are "multi-million dollar questions," according to Dr Izzy Nelken, president of US-based Super Computer Consulting, Inc, and author of 'Hedge Fund Investment & Management' (Elsevier, 2007). "Only time will tell," he adds, speaking to Business Line about the current crisis in the financial world.

Dr Nelken, who is a Ph.D. in Computer Science from Rutgers University, is a lecturer in the Mathematics Department of the University of Chicago. His company, Super Computer Consulting Inc., specialises in complex derivatives including exotic options, volatility products and credit derivatives.

Excerpts from an interview.

How extensive is home mortgage in the US?

In the US, most people do NOT own their homes. The estimate is that 70 per cent of the population borrows (that is - take a mortgage) in order to purchase primary residences. In many cases, the builder (or home seller) will give the buyer a cash rebate upon purchase. This makes the "official" purchase price of the dwelling higher than the actual price. So, in many cases, people can borrow up to 95 per cent to 100 per cent of the value of the residence.

What factors contributed to the growth of mortgage?

As you know, the Federal Reserve has been lowering interest rates. In mid-2003 the ten-year rate has reached a low point of just over 3 per cent. As many mortgages are based off the ten-year Treasury rate, the mortgage rate has dropped down substantially. And so, many people who couldn't afford to purchase were suddenly able to. In addition, most financial institutions were "flush with cash" and so they started making loans to "risky" borrowers.

Which is how we have the sub-prime category?

Yes, this 'risky' category would include people who did not have permanent, full time jobs and others.

Was the interest rate fixed or variable?

Instead of taking fixed rate loans, many people were advised to borrow on 'adjustable rate mortgages' (ARM). These loans may have lower payments initially but as soon as interest rates increase, so would the payments of these mortgages.

How do hedge funds get into the picture?

In many cases, the payment streams that are generated by these mortgages were "packaged' and sold to investors as 'mortgage backed securities' (MBS). Some investors would take the lower credit tranches of these MBS. These would expire completely worthless as soon as even a few borrowers would default on their mortgages. Many of the investors in assets with lower credit quality were hedge funds.

Why?

As long as the real estate market is booming, there is no problem. People would

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continue to pay off their debt. Even if they were not able to, the value of the property (the collateral) would keep on climbing.

Did things begin to turn sour?

True. In many parts of the US, the real estate market has stalled or even declined. In addition, the ten-year rate has started to climb. It currently stands at over 4.8 per cent. This means that homeowners were faced with a "double whammy". The value of their property declined and their adjustable payments increased. Many of them could not keep up with their payments.

And, as a consequence?

The mortgage holders are also facing difficulties. In many cases the value of the mortgage is now larger than the value of the collateral (since the real estate market has declined).

When hedge funds invested in securities with such low credit rating, why didn't they hedge themselves?

This question can be answered by noting that since 2003, credit spreads (and bankruptcy rates) have been on a decline. This caused massive problems for investors. In order to generate yields over the risk free rates, they had to resort to buying riskier securities. Further, hedging off the credit risk would only degrade performance as compared to a non-hedged investor. Hedge funds then got compensated to either under-hedging or not hedging at all. This strategy has paid off tremendously since 2003.

But now, things are different?

Yes. The sub-prime crisis combined with a rise in implied volatility and credit spreads have forced many funds to face margin calls and liquidate assets. Many have had to sell whatever assets they could, including unrelated stocks.

Then?

This further depresses the stock market and drives up credit spread and volatility. This forces the banks to issue more margin calls and so on. This is the cause of the liquidity crisis (lack of access to cash).

Countermeasure?

The ECB (European Central Bank) as well as the US Federal Reserve have announced that they would provide liquidity to the system.

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