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Translating the volatility in the capital markets to investment decisions

BY TODD CLARKE | GUEST COLUMNIST

Recent events in the subprime market have proven there is nothing as consistent as change. Understanding the components that brought about this change is what separates an astute investor from a lemming.

Contrary to the recent 24/7 TV coverage on the subprime mortgage market meltdown, underperforming subprime loans make up a small percentage of all subprime loans, which, in turn, make up an even smaller percentage of the overall mortgage market.

So why the panic?

It all boils down to risk and liquidity.

Investors price what they are willing to pay for an investment based on the risks — most risks can be easily discovered through due diligence. So whether an investor is buying an apartment building or a tranche of mortgage backed securities, most of the variables that provide the cash flow from those investments can be easily ascertained.

Liquidity is created when there are an abundance of investors willing to risk their capital in return for a reasonable return for the risk taken.

The post-dot.com meltdown has seen excess liquidity shift into residential and commercial real estate, compressing investor returns to the point where the "spread" between risky and not-so-risky investment vehicles shrink to about 6/10 of a percentage point (or 60 basis points).

Said another way, investors would rather have their money in a market earning a return rather than have their money in the bank earning a minimal return — in fact, this creates a bit of the lemming effect, where everyone is doing it, so it be must be the thing to do.

Like all good things, this train ride was inevitably going to come to an end; the question has always been what will bring it to a stop and how fast will the brakes be applied? Economists had predicted that likely derailment would be caused by one of the cars pulled by the train including: decreasing employment, increasing inflation, or a popping in the housing bubble.

But this derailment was caused a failure of the rail infrastructure.

In previous capital market adjustments, temporary illiquidity has been caused by investors pulling their capital out of risky investments and moving them toward safer investments.

Since then, Wall Street has responded by creating complicated mortgage products that piecemeal mortgages or investments into separate components (cash flow, appreciation, depreciation, principal reduction, etc.).

Each of these components was run by the rating agencies who measure risk to determine the likelihood of repayment. The goal of Wallstreet was to get each piece graded as high as possible (meaning little risk) and then sell off the pieces to investors — making the sum of the pieces worth more than the original whole, thus adding value.

The problem during this adjustment is that investors like banks and mortgage companies that purchased these components based on models that were rated as high grade, low risk investments have found that a small percentage of these were low grade, high risk.

Surprised to find these hot potatoes in their own portfolio, investors are unable to evaluate the risk in competitors' portfolios, which has frozen the large ocean of banks who loan to other banks on a daily basis.

The Federal government addressed this recently by stepping in and reducing the rate at which banks can borrow from the Feds, creating competition for the banks that were concerned with unforeseeable risk in short term lending.

As the capital markets (i.e., sources of funds to finance debt and equity) and the real estate market are entangled, understand how mortgage companies and banks are reassessing risk is vital to the savvy investor.

After a 5-year wave of coastal investors rolling into our market and knowing that were California goes, New Mexico follows.

I recently attended an investor conference to see how the CEOs of banks and mortgage companies perceived the future.

The following is a consensus of opinion:

- This latest shakeup has shaken out the weak, uniformed lenders and investors, creating less competition
- Pricing on debt and equity will move back toward appropriate risk
- Focus on real estate risk will be back to brass tacks management issues and investor experience (90 percent of all foreclosures are related to management issues)
- Dequity (debt+equity) funds will slowly dry up
- Expect a 60-day to 180-day adjustment period as lenders reshuffle the deck and remodel risk
- Interest rates on commercial properties will see a modest long term increase, while residential and apartment loans will still be hovering between 6 to 7 percent, fully amortizing (interest only loans are gone)

And the largest consensus was that those who have money will "keep their powder dry" watching for an opportunity to snatch an investment from a panicked, ill-informed lemming investor.

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