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A dangerous climb

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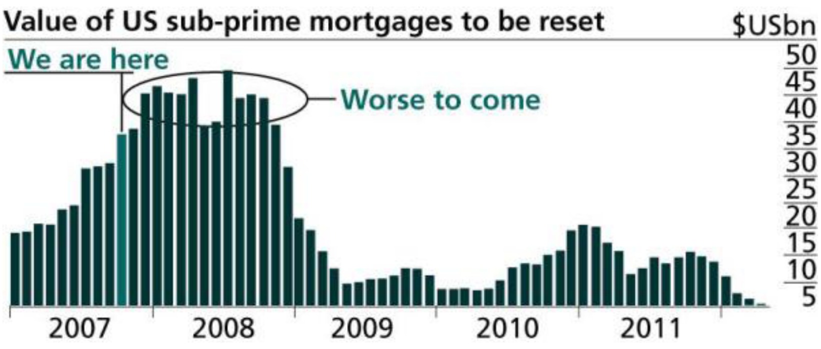
PORTFOLIO POINT: Sharemarkets are heading for a painful repricing of risk, in the way debt markets have just done.

The shudder through debt markets in recent times could well be minor when compared to the one that will hit eventually.

It is extraordinary that leading up to the interest rate cut in the US last week the equity markets were within 5% of recent and all-time highs, so claims that the market has recovered from fears of a recession seem incredible.

The equity markets have shown a blind eye to risk. Consider the news ignored in recent weeks:

- A run on deposits of a leading UK lending institution, Northern Rock.
- The refusal of debt markets to roll billions of loans by mortgage financiers.
- The injection of billions by central banks to keep the interbank market liquid.
- The numerous announcements of margin compression by banks leading to repricing of loans.
- A review by JP Morgan of the Australian mortgage market showing there are 600,000 Australian households which are under mortgage stress.
- Announcements by US-listed companies of write-downs of loan investments that were not previously disclosed.
- The imminent redemption of billions from international hedge funds to be met by September 30.
- The wave of repricing of US sub-prime mortgages from honeymoon rates to market rates in the next three months.



While it is true that the equity markets always climb a wall of worry, it seems to me that this market is climbing blind with no rope.

Finally, should we be excited by the Dow Jones rising by 3.5% in two days last week? Maybe not when you note that the US dollar devalued by 3.5% against the Australian dollar at the same time.

It is universally agreed that there was extraordinary mispricing of risk in debt markets. In recent months the participants in debt markets have adjusted their view on pricing of risk. In simple terms this has resulted in interest rate increases to borrowers commensurate with their risk profile.

Thus, borrowers with poor balance sheets and cashflows will now pay a higher interest rate for their loans. This only relates to floating loans that can be immediately adjusted by the lender due to market price changes. Fixed-rate loans to substandard borrowers cannot be adjusted. However, their face value or security value will drop. Thus, floating rate borrowers will bare the cost of the adjustment and lenders will bear the cost of adjustment to fixed rate loans.

Hence the upheaval in debt markets as different types of loans and securities are repriced or renegotiated. Where repricing or renegotiation can't be agreed or set then the market becomes a vacuum. We saw instances of this in recent weeks and particularly in the sub-prime markets in the US and UK.

So what is a sub-prime loan? Well it appears to be loan negotiated by a financial institution (the originating lender) directly or through an intermediary (the broker) to a borrower whom has a poor balance sheet or suspect cash flows. Such a borrower is normally a household whose balance sheet represents a highly geared house and whose salary is low. Thus sub-prime is a synonym for sub-standard.

The interesting thing about the sub-prime market is that neither the financial institution nor the broker actually lends their money to the borrower. The loans are "securitised" by investment banks ("the structurers") into funds and resold to "investors". These investors are made up of pension funds, councils, hedge funds, government entities and private individuals and others.

The beauty of this system is that fees are generated to the originator, the broker and the structurer. These fees are deducted from the interest payments made by the lenders. This results in the investors receiving a lower return then they would have by lending direct to sub-standard borrowers. So for being transferred all the risk the investor receives a lower return then the actual market rates.

The equity market

If the debt market has mispriced risk, then has the equity market similarly mispriced risk? If the participants in the debt market are also participants in the equity market then, it follows automatically that the pricing of risk in the equity market must be flawed.

Equity is the ultimate unsecured investment. It is serviced only after lenders and creditors are paid. Employees are paid before equity holders. Executive payments and payouts are made before equity is serviced. An equity holder cannot redeem their investment. An equity holder need not receive a dividend. An equity holder ranks behind all debt holders and creditors in a wind up.

The mispricing of risk in the equity market can be shown by numerous illogical equity structures. A telling example is a toll road development. An equity investor in a toll road investment is invited to contribute $1 per unit. The development is to take five years and during construction the developer agrees to pay 5¢ per year in tax deferred distributions.

In effect the investor has subscribed 75¢ of equity (which will yield nothing for five years) and 25¢ as zero coupon loan note, which has principal repayments of 5¢ per annum.

Would any sensible lender lend money for no interest and no security? No, but an equity investor would and this is the ultimate mispricing of risk. Further, who creates these equity structures? The same investment bankers whom created sub-prime securitization.

So what is the better loan? One to a sub-prime borrower at honeymoon rates with security or one to road builder for no interest and no security? ◆

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