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Leverage Demystified

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The past several weeks of continued downdraft in the stock market has been relentless, and for me personally, exhausting.

I want to share with you some of my recent thoughts on the current state of affairs and help you better understand what is happening and why.

One of the key themes in the news has been "leverage" and the needed "de-leveraging" of America. It can seem so obscure when we hear that Morgan Stanley and Goldman were levered at 30 times. What does this really mean? Saturday's Wall Street Journal had an article about corporate executives who have bought shares in their own companies with money borrowed from banks (and secured by the shares). The shares have fallen so far that now the banks are demanding the loans be reduced/repaid or the customer providing additional security. These executives have chosen not to send the bank more cash but to let the bank take the shares and sell them to pay back the loan.

1) Excess demand - These executives were able to buy more stock with the bank loan than they could have without borrowing, creating additional demand for the shares than there was cold hard cash to pay for them. This happened with executives, other individuals, hedge funds and investment banks. When you hear that investment banks were levered at 30 times, that means that they borrowed $30 for each dollar of "equity" they had.

2) Excess supply - When the "de-levering" happens (when the bank sells the shares to repay the loan), the borrower is lucky to get all their loan paid back, let alone have anything left over. The investor doesn't take his or her money from this investment and look to reinvest into something else, there is often simply nothing left of this investment. When more and more lenders are de-levering these arrangements, they sell more stock which can drive the price down further, forcing others in the same position to sell more stock.

3) Credit crunch - In this example you can see how banks are in the mode of reducing their lending to existing customers and how they might not be so keen on making more of these types of loans right now. Parallels can be drawn in the real estate markets, both residential and commercial. Taking it further, when banks lose money on some of these loans it reduces their equity and their ability to borrow. Banks previously freely lent to one another, but now they are wary of a bank failing and creating more losses for them, so banks that need to borrow have to turn to the lender of last resort, the Federal Reserve. In the same way, investors now are wary of lending to corporations (through the purchase of bonds or commercial paper) because they are concerned that the corporations may be the victims of the credit crunch and while they may have great assets, they can't pay tomorrows bills and so they may declare bankruptcy and the investor takes the hit.

When will all this excess supply stop flooding the market? When do we reach equilibrium of supply and demand of stocks? When will banks and investors have the confidence to lend again? Ahh, the $64,000 questions. Maybe it was Friday. Maybe next Thursday. Nobody knows.   There is a lot of money in mattresses, in treasuries and money market funds waiting to go somewhere. Usually investors go from stocks to bonds when stocks get too richly valued and from bonds to stocks when yields get too low. Right now they aren't favoring either the stock or bond market. The de-levering process and credit crunch do take money out of the markets, some of which is a good thing, all of which is a painful thing.

As a long-term investor I try to stay tuned into the markets, always with a focus on valuation. I look at things as if I owned the entire company, what cash flows would I enjoy from the company and how does that relate to the price of the stock or the repayment ability on a bond. I am seeing lots of stocks that I realistically think I could get 10% returns in cash on my investment, and these are companies that have very sound finances. In an environment where a ten year treasury bond yields under 4%, and a one month treasury bill yields 0.4% annualized, many stocks are quite attractive.

Stocks have gotten very cheap. They may get cheaper. Reviewing risk tolerances and making sure you have enough cash to do what you need to do in the short-term are the main things for you to focus on right now. History shows that these markets recover. Is it different this time? Yes and no. It is always different - different economy, different government reaction, different lots of things, but the history is like that too and the markets have still recovered.

I hope this helps frame things a bit better for you than the talking heads you see on television or hear on the radio daily. I am happy to discuss things with you further.

Thank you,

Timothy G. Parker, CFA