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Knowing What Hit Us

The unprecedented sharp global market downturn over the past weeks has brought to fore a roster of terms and concepts. These include the subprime mortgage crisis, CDOs, hedge funds, Fed Funds rate and Discount rate. Given the number of questions and inquiries we have been getting on these topics from our readers and investors, we thought it would be helpful to discuss these as part of our continuing investment basics series.

The Subprime Mortgage Crisis

To understand this malaise, let us first define **subprime mortgages**. These refer to loans granted to borrowers with impaired or no credit history. These borrowers normally do not qualify for market interest rates because of their questionable ability to afford the monthly payment on the loan that they are applying for. Subprime mortgages are therefore extended at a higher interest rate. The combination of high interest rate and the questionable credit history of the loan applicant render subprime loans as generally risky.

Despite its risky nature, subprime lending became popular in the US during the housing boom that took place in the past years. But when the housing bubble eventually burst, the decline in property values and rising interest rates led to a sharp rise in defaults among subprime mortgage borrowers and foreclosures on their properties. This took a heavy toll on subprime mortgage lenders who were forced by the crisis to close shop or declare bankruptcy. Publicly listed lenders saw their share prices plummeting after they announced heavy losses or declared bankruptcy.

Collateralized Debt Obligations (CDOs)

CDOs are a type of asset-backed security (ABS) and structured credit product that have exposure to a portfolio of fixed income assets. They were first issued in the 1980s and have since become popular to investors.

The basic principle of a CDO is that it invests in fixed-income assets. The cash flows from the investment portfolio will then be distributed in tranches depending on seniority (senior or rated AAA first, then AA to BB, and lastly to the unrated or equity tranches). Losses are applied in reverse order, with greater protection given to the senior tranches.

The trouble arose when CDOs found their way into assets backed by subprime mortgage bonds. When subprime loans were hit by delinquencies and defaults, CDOs exposed to these suffered rating downgrades and decline in value.

Hedge Funds

Hedge funds are privately-owned investment funds and are generally unregulated in contrast to other funds (such as mutual funds). Since they are unregulated, they do not have to report regularly on their holdings.

The compensation of hedge fund managers are based on the returns that their funds earn. This kind of a pay structure motivates hedge fund managers to achieve returns that are above market.

Hedge funds are highly levered and use sophisticated investments such as derivatives. Unfortunately, their funds have also found their way into derivatives involving mortgage-backed securities. There are no data yet as to how much of these are exposed to subprime mortgages. Suffice it to say though that two hedge funds managed by top US asset management firm Bear Stearns have collapsed.

Fed Funds Rate and Discount Rate

Interest rates are closely watched by the stock market because they can indicate the economy's direction. Two key interest rates in the US are the **Fed Funds rate** and the **Fed Discount rate**.

- The Fed Funds rate is the rate banks charge each other for overnight loans of reserve balances. In the US, banks are mandated by the Federal Reserve (central bank) to maintain a certain balance of cash (or reserve balance) on deposit at their local Federal Reserve branch office at any given time. When the reserve balance is inadequate, banks borrow overnight at the Fed Funds rate.

  The Fed Funds rate is set at a specific level every month by the US Fed through its Federal Open Market Committee. The Fed uses this rate to control inflation and maintain the economy's health. This rate also influences other interest rates in the US. A higher Fed Funds rate would lead banks to lend at higher rates since they themselves would be borrowing money at a higher rate. With the higher cost of money, businesses will be discouraged to borrow and thereby slowing down economic activities. The opposite is true when the Fed Funds rate is cut. A reduction in the Fed Funds rate usually perks up the stock market.

- The Fed Discount Rate is the rate at which the Fed lends to banks through its discount window. It is usually a percentage point above the Fed Funds rate. To maintain solvency, the Fed requires bank to maintain a reserve requirement. However, when banks loan out too much for a particular day, they need to borrow from the Fed's discount window to make sure they have adequate reserve requirement.

We realize that having a good grasp of these concepts can help increase our understanding on what has been hitting the global financial markets lately. Such knowledge should come handy and helpful in our own investment strategies. After all, as we have seen in the recent past, our stock market is not immune to global developments.

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