

# Lessons of Sub-Prime, Value versus Price:

## Why high liquidity in the Gulf markets is a bad thing for investors...

**Brett King and Dr. Richard Petty**  
Board of Standards

The collapse of the so-called US Sub-Prime Mortgages market in the third quarter of 2007 was a wake-up call to the US, and indeed, the global financial market. Since the deregulation of the financial services sector in the US starting in the mid 1970s, the trend has been increasingly about structuring equity and debt in more creative financial instruments and to trade those thru the capital markets.

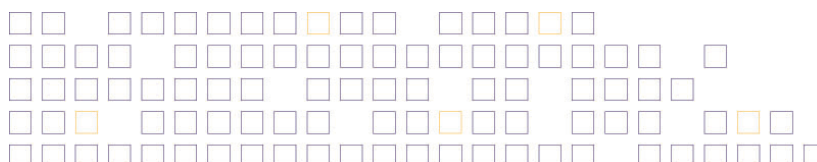


Initially these financial instruments started as simple products like equity funds (or mutual funds) where portfolios of individual stocks were aggregated to provide the average investor access to a more diverse selection of investments. Then we started to introduce more complex contract agreements to 'hedge' positions or risk, and finally the financial engineers started to create specialized derivatives, structured products and instruments to trade. The US Sub-Prime 'bond' was the latest mathematical incarnation in this trend, with the creation of so-called Special Purpose Vehicles (SPVs), Structured Investment Vehicles (SIVs) linked to Collateralized Debt Obligations (CDOs) and special issue bond instruments.

Sub-Prime was so-called because these were mortgages on properties in low income zones, owned or rented by low income earners, and could not be expected to achieve significant capital gains in the medium-term, in other words risky mortgage propositions compared with other residential property (or sub-prime return profiles). The banks figured out they could create bonds or separate subsidiary entities that could hold the debt that included sub-prime mortgages. SIVs made their profit by buying high-yielding long term debt, especially CDOs containing sub-prime debt, with funds raised from long-term bonds on which they paid a lower yield, in theory hedging or balancing the risk. But low-inflation, a declining US dollar, and short-term interest rates made it difficult to keep hiding the debt off the bank's balance sheet and showing a profit from these sub-prime investments. Eventually, the market was simply not prepared to keep paying for this debt when the long-term benefits were just not going to be realized.

### SUB-PRIME LOSSES SO FAR

- UBS: \$13.5bn**
  - Citigroup: \$11bn**
  - Merrill Lynch: \$8bn**
  - Morgan Stanley \$9.4bn**
  - HSBC: \$3.4bn**
  - Bear Stearns: \$3.2bn**
  - Deutsche Bank: \$3.2bn**
  - Bank of America: \$3bn**
  - Barclays: \$2.6bn**
  - Royal Bank of Scotland: \$2.6bn**
  - Freddie Mac: \$2bn**
  - Credit Suisse: \$1bn**
  - Wachovia: \$1.1bn**
  - IKB: \$2.6bn**
- Source: Company reports*



## Value versus Price

The simple issue here is that the market created a complex financial instrument in order to hide the 'spread' between the price (or traded value of the sub-prime property) and the real value of the same underlying assets. The expectation of the banks was that as interest rates rose and the value of the US dollar started to appreciate again, that that spread would reduce and the trade-off in value would be neutralized. The problem was that the equalization in value/price never occurred and eventually investors said enough is enough.

There are a number of reasons why this price/value equilibrium can be disturbed in a financial market, such as:

- **Credit Excess**  
From the Dutch Tulip craze of 1630, to the US stock market boom of the 1920s and the Asian Tigers boom of the 1990s, these imbalances occur when larger number of investors 'borrow' to fund investments in the hope of future value gains
- **Market Speculation**  
You may have heard the old adage "buy on rumor, sell on fact". Well on occasion speculation drives the rumor mills to unsustainable levels, where traders are betting the market will continue to go up on the basis of trading activity or volume, but the underlying price is unsustainable. You know markets are highly speculative when the market already appears overpriced and the traders are focused on selling you capital gains of 20-30% in a few months based on CAGR.
- **Fraud and the hiding of real debt off the balance sheet**  
Primarily this would occur with individual funds or equities where the fund or company itself is hiding the real financial situation in order to keep transaction volume high. A prime example of this was ENRON, where billions of dollars of debt had been hidden by Enron and Investment Banks and traded off on the continued growth of Enron's stock. When the share price went down, the house of cards collapsed because the value of the stock was clearly overpriced in the market.

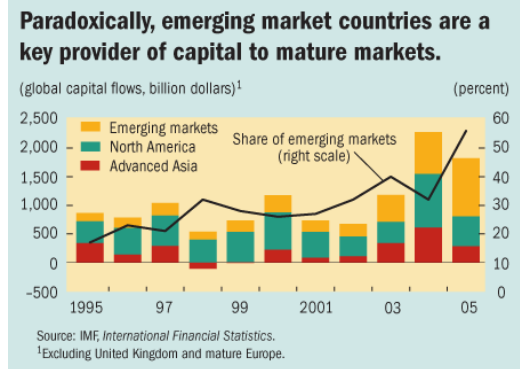
## The Gulf Markets: High Inflation or Speculation?

The oil rich Gulf States Sovereign Wealth Funds are currently capitalizing on the sub-prime crisis by investing in adjusted stocks. However, there is another reason that the Gulf States are looking to diversify outside of the Gulf, and that is because they face a price/value inequality in their own markets. This is particularly the case in the United Arab Emirates, Qatar and the Kingdom of Saudi Arabia where the real Inflation rate continues to exceed 8-10% per annum and in the case of Doha and Dubai probably in real terms is well over 14%

The cause of the highest inflation in the Gulf is a result of significant over-valuation in property markets. With high liquidity due to record oil prices, both the capital markets and property markets have suffered from speculative trading and supply/demand imbalance.



To see how this has happened we can track capital flows in the last 10 years and see that the Gulf region started to accumulate cash post 9-11, with investors pulling Billions of \$ out of the US market. The low US dollar and low interest rate environment has continued this trend. With rising inflation, investors sought refuge in local investment opportunities rather than face negative interest rates. This created a bubble of liquidity which first impact the stock markets of the GCC in April of 2006, where the Saudi market had the biggest one day loss in all of recorded history, in excess of 55%. But the lessons weren't learned there.



In 1999 Dubai Emirate in the UAE, became the first Gulf state to offer freehold property. This is significant, because before this date only Arab Nationals were able to hold property in the Gulf. Suddenly the Dubai property market was born. Since that time rental prices have increased up to 100% in some areas within a 12 month timeframe, and property owners of freehold properties have enjoyed capital gains of 30-40% before construction is even finished. In this environment, could a two bedroom apartment in Dubai Marina really demand the same price as a 2 bedroom apartment of similar size in Canary Wharf or the Docklands in London? Such prices are clearly not sustainable.

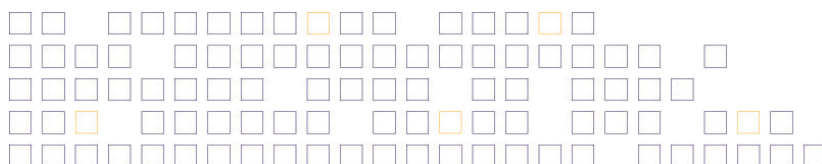
- 2 Bedroom Apartment Docklands ranging from £150-400,000
- 2 Bedroom Apartment Dubai Marina from AED 1.2m-3m

Some would argue this is just a case of supply and demand economics, with Dubai growing at 19% annual GDP growth, there is simply not enough supply to satisfy demand. However, the Sovereign Growth Funds are clearly moving away from the local market in expectation of a significant adjustment. At the same time, Mortgage brokers are starting to move away from offers of 95-98% finance, and are retreating to 70-80% of the asking price so as to avoid negative equity after the market adjusts to more moderate pricing levels.

**Why Sovereign Wealth Funds (SWF) are running to invest in Mature Markets**

On January 15th the governments of Singapore, Abu Dhabi and South Korea provided much of a \$21 billion lifeline to Citigroup and Merrill Lynch, two banks that have lost fortunes in America's credit crisis. China Investment Corporation has invested over \$5 Bn into Merrill Lynch, and \$3Bn into Blackstone. Temasek invested £2 billion into Barclays, and Standard Chartered received £4.25 billion from the Singaporean group. Abu Dhabi Investment Authority, reportedly worth over \$875 Billion, took a 4.9% stake in Citibank for \$7.5 Billion. Dubai Investment Company likewise took a stake in HSBC.

Why aren't these sovereign funds investing in the Gulf property market or in Gulf capital markets to the same extent? Clearly they see better investment opportunities outside of the Gulf at this point in time. With a low US dollar and big players such as Citi, UBS and HSBC in real trouble, the SWF cash is a welcome solution.



## Will the outflow of capital last?

Before the Sub-Prime credit crunch, American politicians had vociferously objected to Arabs owning their ports and Chinese owning their oil firms. On January 15th Hillary Clinton said: "We need to have a lot more control over what they [sovereign-wealth funds] do and how they do it." Once the Sub-prime emergency has passed, perhaps this foreign money will be far less welcome, and the Sovereign Wealth Funds will return to their home territories to seek local opportunities.

For now, however, the prices in the Gulf property markets in particular are not a realistic representation of the value of the underlying assets. While the Asian and Gulf capital markets may have some sector opportunities, those also face the problem of price/value imbalance. So the Sovereign Wealth Funds are showing us the way, because if the capital gains look too good to be true, they probably are...

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