

Spotlight on Leverage

Leverage refers to the degree to which invested cash is magnified in its purchasing power or market effect. We call this debt leverage because of the way it can greatly increase purchasing power, just as a lever can help a person lift an object that is many times heavier than she is. Leverage is risky because it amplifies both gains and losses.

The most common example of leverage is mortgage debt – a homebuyer buys a home paying perhaps 20% of the selling price and borrowing the other 80%. In this manner, the risk of owning the home is split between the homebuyer and the lender.

Let's say that you bought a house for \$500,000 in 2004. You borrowed \$400,000 from the bank and made a \$100,000 down payment. You sold the house to in 2006 for \$700,000, paid off your loan, and tripled your equity, even though the price had risen by only 40%. Your leveraged bet worked for you because the price of your house appreciated.

Now let's look at the person who bought that house in 2006. We'll call him Joe. Joe borrowed \$550,000 from the bank and made a \$150,000 down payment. In 2009, Joe is in trouble because he needs to move and his realtor tells him that his house would sell for only \$400,000, just like it had in 2004. If Joe sells his house now, he will not be able to repay the bank. His equity will be wiped out. He will have a terrible time getting any kind of loan again. Poor Joe is upside down in his mortgage. He's being flogged by leverage.

As we have seen, leverage can boost or destroy investment returns. Under good conditions, the borrower repays a loan, creating a profit for the lender and herself. Under poor conditions, however, leverage can multiply the pain. Because the borrower's obligations to the lender are limited to the amount of cash lent, the homebuyer is in a position to benefit disproportionately if she is able to sell the house at a profit. Likewise, the borrower is the first to forfeit her equity (down payment) if she must sell her home at a loss. The lender incurs a loss only if the borrower fails to pay (defaults) or sells the home for less than the loan amount.

There are many ways for an investor to take on leverage, from borrowing cash to invest in securities (margin borrowing) to using derivatives (big payoffs for the winner, big expenses for the loser) or to buying securities that incorporate either debt or derivatives.

Surprisingly, even if you have not borrowed a penny, the enterprise in which you invest could itself have debt that leaves it vulnerable to changing market conditions. Real estate investment trusts (REITs) are a perfect example of this – they borrow money to finance their real estate holdings. If the value of their properties declines, their lenders may impose penalties or demand repayment. This leaves them cash-strapped and unable to return capital to their equity investors.

Sometimes borrowing done by others can help or hurt you, even if you are totally debt-free. A major reason that home prices rose for years was that borrowers had an easy time getting loans, and so had plenty of purchasing power. They used it to bid up home prices.

If you sold a home in 2006, you were a tremendous beneficiary of leverage. However, if you were a homeowner in 2008, you saw the value of your house fall because the foreclosures on bad loans created excess supply in the housing market.

Similarly, for shareholders, if others who hold the same shares that you do are levered, either by borrowing against those shares or by other borrowing, they can be forced to sell their shares if the prices of their collateral begin to decline. We saw this in the autumn of 2008, when hedge funds needed to sell lots of stocks in order to pay off lenders who demanded cash against losses on complicated bets that had gone wrong. The companies whose stocks they sold hadn't changed their business outlook from one day to the next. The hedge funds sold the stocks because they were liquid and could fetch cash in a hurry. Unlevered holders of those stocks saw the value of their holdings plummet because of the forced selling by levered players. Why were the hedge funds levered in the first place? Remember: in good times, leverage boosts returns.

How do we protect ourselves against the risks that leverage brings? We make sure we understand our own levels of indebtedness and the direct leverage that is built into our investments. We try to estimate the leverage of the entities in which we invest. This gives us some way to predict how market changes will affect our portfolios. We avoid leverage unless we determine that the rewards are likely to outweigh the risks. We let you know if an investment we are recommending depends directly on leverage.

While we cannot control the borrowing done by others, we can sometimes wait out the consequences, or even take advantage of the opportunities that forced selling creates. Taking a long-term view, and being in a position to spot opportunities, we are able to position our portfolios to create value over time. Even if we get caught in a leverage storm, we will not be forced to lock in a loss unless we join in the waves of selling.

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