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Unless you've been living on Mars, you're almost certain to have heard about the so-called sub-prime credit woes besieging both US borrowers and world-wide financial markets.

Many of the angles to this crisis have been covered, however one perspective that's been largely overlooked is the likely impact for property investors.

Read on to discover a no nonsense Aussie perspective to understanding the sub-prime debacle.

If you can spare me five minutes, then I'll tell you everything you need to know as well as provide you with four tips on how to protect your investment nest egg, and perhaps even capitalise on any uncertainty.

The Problem

Many in the media have spruiked a convenient tale that US loans were being handed out to the financially destitute like lollipops to children. However, spend 32 seconds scanning the internet and you'll quickly discover that's not what's really happened.

In fact, if that was the problem then there would be an easy solution – regulate mortgage lending and hey presto you'd have a quick fix. No, the issue here is both wider and more alarming than simply assuming the wrong people were given the wrong finance.

If you always try to make a financial killing, then you constantly risk being killed!

The problem was that people forgot the simple rule that when you spend more than you earn, you'll eventually end up broke – particularly if you borrowed the money to begin with.

What happened in the US was that the economy grew fat on equity fuelled spending, so that when house prices stopped growing and began declining, the debt was left without the value.

For example, when you use debt to buy depreciable items (like plasma TVs and I-pods) then the value of the purchase quickly depreciates once you start using it, yet the debt is a lot harder to work off.

Sub Prime Hiccups

Sub-prime debt is a fancy way of describing second class loans. Here in Aus we tend to use terms ‘non-conforming’, or ‘no doc’ loans to describe fringe mortgages.

Without wanting to oversimplify the problem, the crux of the issue stems from average Americans over-borrowing. That is, when the prime mortgage market restricted how much they could borrow, borrowers hopped over to the sub-prime alternative where more money was being offered at higher interest rates.

Not used to consuming under their means, the greed mentality meant that as much house was bought as the maximum amount that could be borrowed allowed.

A comparison can be drawn with Aussie loan products. Some in the second tier advertise up to 105% of the purchase price of a home can be borrowed, yet the big four banks usually take a more conservative approach where lending is capped at approx 80% of an independently verified valuation. Beyond that, mortgage insurance is needed.

**Most Loans In
The US Are Fixed.**

Unlike here, the majority of home loans in the US are fixed for the life of the debt – even up to 25 or 30 years. The variable rate alternatives are called ARMS or Adjustable Rate Mortgages.

Now, because the US mortgage market is quite sophisticated, there are many different types of adjustable rate mortgages on offer. However, a common variety is a 2/28 ARM. Under this loan, the interest is usually heavily discounted and set as interest-only during the first two years, but thereafter resets to market plus a healthy interest margin.

And here’s where things go wrong.

**The US Housing Market
Was A Lot Different Two Years Ago!**

The US housing market was a lot different two years ago. Prices were going through the roof and people were doing just about anything to get a foot in the property door. Remembering that the initial ARM interest rate was often heavily discounted, one popular strategy used by borrowers was to get a cheap 2/28 ARM with the view of refinancing to a fixed term loan when the debt reset after the two-year intro period.

Sadly, as interest rates rose and the general property market softened, today many find themselves in the poo because the value of their house has gone down the toilet, their loan has stayed constant (interest-only) and their interest payments are due to rise sharply as the rate is adjusted to market plus a margin.

If you’re wondering why people would ever think about doing such a thing, here are two common-day similar instances that happen here:

1. Two-Year Interest Free: Many furniture sellers offer two-year interest free periods. People think they'll comfortably pay it off but lenders know a good percentage won't and will be slugged up to 24% interest.
2. Credit cards offering up to 55 days interest free. Pay on the 56th day and you will get charged interest from day one at up to 19% per annum!

The sub prime mortgage market isn't full of dud borrowers.
It's full of properties where the debt is greater than the value.

The truth of the matter is that the sub prime mortgage market isn't full of dud borrowers. It's full of dud properties where the loan is greater than the value, and hence people are considering walking away rather than paying top dollar for a dud.

Remember too that going bankrupt in the US holds little, if any, of the public disgrace and shame that it does here. It's more of a case of 'oh well – I'll downsize and start again.'

World Wide Problem

Now that we know what went wrong (namely negative equity when loans were due to reset), the next issue to chew though is to try and understand why this is a world wide problem.

The answer is: **loan syndication**.

The second tier mortgage market is characterised by the fact that the loan funds do not originate from a deposit base. Instead, the money must first be borrowed (from financial institutions, fund managers and big players via money markets), and then subsequently on-lent via mortgage originators and brokers through to the end customer.

Taking another perspective, the loans were bundled up in the US and then sold to foreign investors as first-mortgage security.

That's great, but when the economy takes a dive then accounting standards require that the value of the debt be written off to current realisable value. If there are any doubts then it must be written off entirely.

Enter panic. As more lenders are forced to write off their debts, questions about the solvency of companies holding the assets are called into question. Lenders start to become a little jittery, and so to compensate for the extra risk, they demand higher returns on their money and this is achieved by raising interest rates.

This is the fear for those holding RAMS loan products. I'm led to believe that a lot of the money lent under the retail RAMS product range is money sourced on world markets. As their cost of finance increases, those charges will be passed on regardless of what the RBA decides to do about their cash target benchmark.

Beware October!

Without the intervention of billions of dollars of support by Federal Banks around the world to

prop up confidence, we'd probably already be in the midst of a major financial correction. Certainly a recession, perhaps a very deep one.

We all know that bad news travels fast. Pictures of people queuing outside Northern Rock branches in the UK wanting to pull out their savings before their bank accounts are frozen hardly instils maximum confidence.

Could it happen here? Why not? Are you old enough to remember Pyramid, Tri-Continental, or the failure of the State Bank of Victoria (bought out by the Commonwealth Bank)? What about so-called safe insurers like HIH?

Imagine the carnage if the housing industry collapsed and mortgage insurers went bust! Game over red rover. Truly though, that's a very extreme possibility, certainly highly unlikely.

What is known though is that October is likely to be a rollercoaster month.

First of all, October is traditionally a shocking time for share markets. Secondly, according to one source, up to 660,000 US ARM loans are due to reset in October.

It doesn't take much imagination to see that an ounce of bad news could quickly escalate into a trend of negative sentiment. If severe enough, panic could result.

Steve's Tips

One of the benefits for those in my R.E.S.U.L.T.S. mentoring program are the regular detailed written investor volumes I send out that are chocked full of information about how to become a more sophisticated and strategic property investor.

As part of my market update for an edition due out soon, I tackled the US sub prime mortgage issue and provided several tips to prepare in advance for what might happen. Here are four of them:

1. Build cash reserves – don't max out!

Cash represents both buying power to snap up bargains and also liquidity protection should the banks start calling in loans.

2. Take profits on marginal property deals

Considering the increasing volatility and likelihood of higher interest rates, marginally profitable deals are more likely to become loss makers. There is no shame in converting equity into realised profits to build a superior financial position.

3. Push Timeframes Hard – Manage, Manage, Manage!

Now is not the time to be complacent and given the uncertainty in the current climate, you'd be very smart to push through on your project timing and avoid delays like the plague.

4. Think Hard About Good Deals That Hog Cash

Good deals are becoming more common, but rather than jumping in, make discerning choices about what you buy.

Summary

The sub prime mortgage market is not a problem that sprung up overnight. It took years to eventuate and it will take some pain before it is healed. With the traditionally scary month of October only weeks away, now is not the time to make a major play on the property market which sees you bet the bank on a speculative deal.

Homework

To ensure you are well prepared, I suggest you consider:

1. Hold off on making any big property investing decisions until after October. In my eyes, unless you grab a red hot bargain, the downside risk is greater than the upside risk.
2. Identify and quantify your access to cash reserves. Having cash will provide good protection and the fire-power to snap up a bargain.
3. Take a realistic financial snapshot and see how well your wealth creation is going. You can do this for free at: www.propertyinvesting.com/wealthscore

That brings us to an end of this month's newsletter. I hope you have found it helpful and informative.

I'm off for a week's holiday up in Queensland. I look forward to being in touch when I return. Until then. Remember that success comes from doing things differently.

All the best,

- Steve McKnight

P.S. If you're interested in finding out more about my RESULTS mentoring program then visit: http://www.propertyinvesting.com/RESULTS

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