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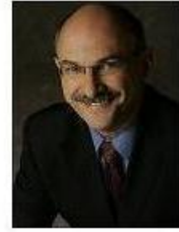

Wall Street: Money Never Sleeps – Reviewed from a different lens

I recently saw the sequel, Wall Street: Money Never Sleeps

The Movie

It's a love story where a young idealist gives up a $100 million dollars because it doesn't fit with her values and where an equally young Gordon Gekko wannabe is mentored by one of the most powerful men on Wall Street who idealistically works to destroy him. There's lots of hugging and crying while Wall Street crumbles in the background, as it did in 2007-2008. And there are lots of confusing speeches which, even after 30 years in the business, I did not really understand.

What I did pick up, though, was something about too much leverage and about there being no limit to the size of the financial destruction - in other words, No Bottom.

So… how does a loss become "bottomless"? The short answer is leverage gone wrong.

First, some background.

The Boring Old Way

For years, banks engaged in the boring but safe business of re-selling mortgage loans to bond investors while keeping a 0.5% fee to cover expenses and make a tidy profit. These mortgage bonds were backed by the U.S. government and so were AAA-rated, and carried a slightly higher yield than long-term U.S. Treasury bonds to compensate investors for events such as mortgage refinancing and pre-payment.

Introducing… CMOs

Then, in the go-go risk-embracing 1980s, Wall Street (remember Salomon Brothers?) introduced a new product – called Collateralized Mortgage Obligations or CMOs in short - where mortgage payments were divided into different cash-flow streams called tranches to suit investors' various needs. For example, someone could buy a slice of mortgage payments over say a 5-year term only and get a correspondingly lower interest rate. The bonds were AAA-rated because the underlying mortgage was still guaranteed by the U.S. Government.

Pushing the Envelope on Risk

CMOs opened up a fascinating new toy-box and Wall Street whiz kids could not resist slicing and dicing these bonds into ever more esoteric formations, till they'd exhausted all possible options.

For example, they separated principal and interest payment streams and offered them separately to investors who wanted the safety of principal or the risks and higher returns associated with rising and falling interest rates.

Now, the interest-only bonds could become worthless if rates went against you, yet somehow, the ratings on these too were AAA.

Leverage

CMOs excited big brokerage firms who saw this as a huge new profit play. Firms like Bear Stearns and Lehman Brothers, to name a few, would buy these bonds with only a minimal down payment – using leverage - then gradually sell them to their customers.

Back in 2005, I had reported here that the average brokerage firm's leverage was 33 to 1. In other words, they put up $1 and bought $33 worth of securities.

As you can well imagine, this was extremely profitable when markets went up. Every dollar of profit magnified returns 33 times and companies made billions.

… and extremely painful when markets went down, where every dollar of loss again got magnified 33 times and companies lost billions.

Reality Bites

Finally, in 2007, the party in housing started to come to an end, and cracks began to appear. Homeowners began defaulting on mortgage payments and bond prices started to fall. That leverage of 33 to 1 began to cause a crisis of unparalleled proportions.

Then in Fall 2008, Wall Street had a heart attack. Venerable companies with tens of billions in cash, such as Merrill Lynch, went bankrupt overnight and had to be bought by stronger banks with guarantees from the Federal Government.

And so the bailouts were born.

Was it <u>all</u> Wall Street's fault? Of course not. Should you have bought the house you couldn't afford, even if some fool gave you the money? Should you have leveraged your home equity to live a lifestyle you could ill afford? No!

Bottom Line

So the bottom line here is that simple rules evolved over the millennia help us live smarter, better lives – spending within our means, saving for a rainy day and selectively using only a little leverage to stay financially healthy. Fool around with these simple rules and you may get hurt.

Oh and by the way, unlike our idealistic 20 year old in the movie, if someone gives you a $100 million dollars, KEEP IT.