Mullooly Asset Show: Ep. 107 - Transcript

Tom Mullooly: In episode 107, we're going to talk about one of the early triggers for the great financial collapse.

Welcome to the Mullooly Asset Show. I'm your host, Tom Mullooly. This is episode number 107. I grew up on Long Island, so 107 meant driving through Hicksville. Anyway, if you live on Long Island, you'll get it.

We're coming up on the 10th anniversary this week of Lehman Brothers checking out, filing bankruptcy in probably what was one of the greatest margin calls of all time ever. How did we get there? It's a very long story. They've actually written books and they've done movies, too, about it. But I want to pick out one episode and it was triggered by a tweet that I read this afternoon from Helene Meisler, we'll link to her in the show notes, and she asked, "Why do people always refer to Lehman filing Chapter 11 as the beginning of the great financial collapse?" Good question. Because she asked, "Wasn't Bear Stearns involved in this, too? And they had checked out six months before."

I responded and said I think we have to go back to the spring of 2007 when all of these subprime mortgage companies finally went under. What a lot of people didn't understand, if you look at a company like, for example, I'm not picking on this one in general, but we've got the details on this one, a company called New Century Financial, one of the largest subprime companies. This is not only a fatal story of how the company just imploded, but it's also a stark reminder to investors that if you load up your account on one thing, one stock, one type of category or one style, and it falls out of favor or it completely falls apart, you can really have some problems. Earlier today, we recorded a podcast. One of the topics, we talked about how some guy lost his entire net worth by betting on cryptocurrency.

New Century Financial. This was probably one of the single hottest stocks 15 years ago. I'm just going to read some of these notes. In 2002, the company was added to the Nasdaq Financial 100 Index. In 2003, they ranked 12th on Fortune Magazine's list of 100 Fastest Growing Companies. In 2004, they moved to the New York Stock Exchange. They actually did $42 billion of mortgages in 2004. New Century Financial in 2005 did 56 billion in mortgages. The Wall Street Journal ranked them as one of the top guns, one of the best performing companies that year. 2006, they ranked second nationally in subprime mortgage origination. They did $60 billion in mortgages in 2006. In 2007, in April, April 2nd of 2007, I remember the day, they filed bankruptcy. Their stock at the time was trading at 10 cents. 10 cents. The month before, the stock had been trading in the 40s. It completely fell apart. They talked about investigations, people were going to be arrested. A lot of problems.

But it wasn't just that particular company. It's not like they did something wrong and no one else did. The whole industry was kind of a card game. Understand, one of the biggest lenders in that business was HSBC. HSBC was funding a lot of these subprime mortgage originators. What they were doing is they would basically say, "We're writing you a check. We want the money back in 30 days, or we want it back in 45 days, or we want it back in 60 days." Short-term lending. These mortgage originators were going out, they were writing these loans, and they would sell the mortgage as soon as it closed. They would sell the mortgage most of the time to Fannie Mae or to some other large purchaser of these mortgages. Fannie Mae did a lot of this business. Then what would happen is New Century Mortgage would get the money back for the loan that they just sold, they would repay the loan at HSBC, and then they would do it again, and again, and again, and again.

Well, the beginning of 2007, interest rates were moving up. HSBC decides, "We don't want to do this anymore. We don't want to be in this business." Then one by one, tick, tick, tick, tick, tick, every one of these subprime companies went out. By the end of 2007, 30 subprime mortgage originators filed for bankruptcy. They all closed their doors.

There's lots of things we can talk about with the great financial crisis, how these subprime mortgages, how it really hurt homeowners. The rates were jacked up and then they couldn't pay their mortgages, how the banks suffered, how the investment banks then suffered. It was a big domino pile, all lined up. Everything kind of worked perfectly, in a bad way.

A couple of lessons to take away from this.

Number one, if you're borrowing short and lending long, don't know if that's really the business model that you want to be in.

Secondly, sometimes these industries work themselves into a frenzy. Look what happened in 2004, '05, '06. It was easy to get loans and prices of real estate just continued to go higher.

The third lesson, the biggest takeaway for people watching this video, is if you tie your money up in one sector, in one class, in one stock, you're really taking a big risk.

Thanks for watching episode 107. See you next time.