High-Risk Lending is ... well ... risky

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NovaStar Financial Inc. (NYSE: NFI) , in some ways the most high-profile of the subprime lending group, led the decline. Through Tuesday, February 20th, its stock price rose modestly, closing at $17.56. But at the opening bell Wednesday morn, it started trading at $11. So it lost nearly two fifths of its value overnight. Things haven't improved. It closed Wednesday at $10. Closed Thursday at $9.25. When the week ended, it stood at $8.48. That's a loss of more than half of its value in the course of three business days.

There's a convoluted history here, but one point worth mentioning is that Novastar's stock was selling for $70 until the appearance of a Wall Street Journal story in 2004, which implied that the company's basic business model (making "high-risk loans to people with poor credit") would prove unsustainable. After that story, the price fell to $30 almost immediately. That figure has served as a floor ever since-it would move upward for a time, only to return to $30. At the close of business back on December 1, 2006, (a date I'm taking at random, because I happen to have that day's price at hand) it was at $30.85. The company had some enthusiastic fans, who made the case that the stock price declines weren't so important as the fact that the company kept paying solid dividends.

The stock also has been a favorite of short sellers, and has become one of the foci of the controversies over short selling in general -- whether public policy ought to make it more difficult or easier, whether certain reporters and analysts are doing the bidding of the shorts, and so forth.

As I've had reason to note in this blog before, the legal sort of short selling generally involves *borrowing* the shares one is promising to deliver at a future date certain to the buyer. The borrowing requirement has, unsurprisingly, fueled the growth of a market for securities lending, and there's been some recent publicity about how that market is going retail -- it isn't just brokerage firms lending out their shares to shorts anymore -- ordinary folk can play. Liz Moyer of Forbes did a story on this subject in December. Her leading example of a stock that gets lent out by this new breed of retail-level lenders? Novastar. She had talked to (unnamed) investors who said they had received an 8% return on lending Novastar stock.

If there was enough interest in borrowing-to-sell to sustain an 8% lending rate, then either (a) markets are irrational, or (b) something was wrong at Novastar. The second of those hypotheses seems to have been demonstrated Tuesday night, when the company announced its fourth quarter figures: a loss that quarter of $14.4 million, or 39 cents per share. This certainly suggests that the dividend stream so re-assuring in the past may dry up a bit in the near future. Analysts polled by Thomson Financial said they had expected a *profit* of 73 cents a share. That's called "missing your number" in a big way.

One of Novastar's long time fans, who has maintained a blog specifically for the purpose of praising this company and stock, sang a swan song this week.

"This will be probably my last writing here. Like most long NFI investor, I am shell-shocked after the conference that took place yesterday, and quite annoyed that I participated in the collective hallucination that led so many into such a disaster. Yes, hallucination, or more to the point, collectice delusion, a variant of the latter." And more in that line.
http://www.nfi-info.net/news.htm

So Novastar's investors had invested in a risky business and they've taken a loss. So what? Well ... we can draw some conclusions here. We can conclude that just because a company is paying dividends steadily doesn't mean all is well. Also, we can say that liquid markets are generally rational beings, the market for securities lending among them, so that when a stock can be lent out for an 8% return just so it can be sold, there *is* a problem.

Finally, vultures don't kill. Vultures just feast off a death. So don't rush to blame shorts. I don't doubt that some shorts are sometimes engaged in some unsavory activity -- because they are human beings, subject to all the temptations of the flesh. But as a market, they perform a valuable role. Vultures or some analogous scavenging creatures serve as part of any sustainable ecology.

posted Saturday, 24/02/07
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