

# Thinking Managers

Robert Heller of [www.thinkingmanagers.com](http://www.thinkingmanagers.com) translates the mysteries surrounding the current “credit crunch” into plain English.

## Crunch Time for Creditors

The fear and loathing that gripped the world credit markets in midsummer should have surprised no one. The panic that spread so fast from Wall Street were the result of some simple but ignored management theories about capitalist economics, the simplest being: what goes up must come down.

Equity investment is so enticing because there is no ceiling – but it works equally well in the opposite direction: it’s a long way down.

At the epicentre of the trembling that surfaced in July was a particular area of suspicious quality – the US sub-prime mortgage market. The securities in question were ‘sub-secure’ mortgages supplied to borrowers with poor credit ratings. The big plan was to pool all these poor quality investments in the hope that, by the law of averages, the really bad mortgages would be more than offset by the stronger ones, so happy investors could enjoy the higher yields of a lower credit rating.

However, there is another simple rule: the higher the interest, the bigger the risk.

A typical private equity deal might see the investors pay £1bn for a company – all but £100,000 of it borrowed – and sell for £2bn as soon as they can. Their return on equity is not double, but nine-fold.

In the midst of this super-abundance, it should still be remembered that the simple management theories still apply.

The higher the gearing, the bigger the risk. If a £1m house is financed with £500,000 of someone else’s money and it realises only £750,000, half the equity is lost. If the sale price is halved, every penny of equity is wiped out. Remember, these levels of gearing are tiny compared with those happily shouldered by the lords of private equity and hedge funds.

If someone claims to have eliminated risk from an inherently risky transaction, don’t believe them.



**About the author:** Robert Heller is one of the world’s best selling authors on business management.