September 14, 2016

Erratifluxis
By Alan Snyder

In case you were wondering, it is true, erratifluxis is not a "legitimate" word but it does describe an unstable condition characterized by erratic fluctuations, an anathema to conservative investors. Hyman Minsky, a long ignored but recently celebrated economist, provides intellectual rigor and suggestions for identifying "erratifluxis" and foretelling such conditions, eponymously named, "Minsky moments."

Minsky hypothesized that the imbalances created by long periods of stability guarantee the next crisis. Stability fosters instability and future fragility. To underpin this theory, he identified three forms of financing. The first relies on future cash flows for repayment ("hedge financing"). The second relies on cash flows to only pay the interest, thereby requiring debt principal when due to be renewed in a subsequent loan ("speculative financing"). In the third, repayment is only achieved from appreciation and sale of the asset ("Ponzi financing"). As complacency builds, financing migrates to the "Ponzi" category.

The homeostatic equilibrium of efficient market theory is a gross oversimplification in his view. While Minsky was a mathematician, his theories were posited much like Platonic ideals, in contrast to a mathematical theorem explaining a sensory perceived phenomenon. Some might call it a noumenon. We would call it helpful in thinking about asset categories in alternative lending.

For example, take his debt troika and apply it to alternative lending, specifically to today's real estate environment. Much commercial real estate financing in our current environment fits into his "speculative financing" category with only interest being covered by cash flows. Worse yet, much of the "fix and flip" financing qualifies as a "Ponzi" category. Fix-and-flippers buy "undervalued" housing, spruce it up with generally modest renovations and then sell them usually, or maybe hopefully, within a two-year timeframe. While U.S. residential housing has generally been appreciating since the end of the Great Recession, has complacency struck? Many in this category finance at 100% of the original purchase price plus the cost of renovation knowing/assuming/relying that the ultimate sale price will be significantly higher. The only way debt can be repaid is asset appreciation from the original purchase price or, from the reserves of the generally thinly-capitalized fix-and-flippers, i.e. home remodeling companies. In the past few years prices have gone up, but will this trend continue indefinitely? For us, there is too much risk to such aggressive loan-to-value structures, which we believe should only be considered with more conservative financing.

Payday lending with its astronomical interest rates is a similar proposition. The siren song of ultra-high yields attracts, but debt is frequently only repaid from another loan. Plus, and maybe with reason, it is under intense regulatory scrutiny.

Much student lending is similar. Here, the loans may never get repaid unless there is additional government intervention with complete forgiveness. The "tell" is the currently estimated 40% default rate on many student loan programs.

The froth in overheated demand for marketplace lending is abating. However, credit standards and proper rate setting, which reflects risk, must recognize the earlier foibles of loans being repaid often from only new financing. Slumbering investors have woken up and the major players have gotten the message by improving credit discipline and raising rates. Investors are demanding taskmasters and appear to have rekindled credit discipline from the major players.

Minsky moments and his financing troika offer a great test for some alternative lending strategies as well as many other investments.

If you are in the 'hood (specifically Dana Point, in Orange County) on September 26, 27 and 28, come share your thoughts in person. We will be at the Context West conference and speaking at the Alternative Lending Summit, an all-day affair on September 28t. We even have a booth, number 522. Hope to see you there.