



An Anatomy of a Collapse: Subprime Lenders

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We have harped for years upon the importance of technical analysis as a tool alongside fundamental analysis within an investment game plan. While it is rarely difficult to make the case to someone uninitiated to technical analysis, it can be difficult to show the benefits quickly. One of the most effective presentation tools that we have developed to convey this message in short order is through the "Anatomy of a Collapse". The concept is quite straightforward and the examples are plentiful, and it typically leaves a client or prospect with a very clear understanding of how important technical analysis can be to an investor. Some recent examples over the years in the "Anatomy of a Collapse" series of articles have been [Marsh & McLennan \(MMC\)](#), [Enron \(ENE\)](#), [Krispy Kreme \(KKD\)](#), [Martha Stewart Living \(MSO\)](#) and [Fannie Mae \(FNM\)](#), and the most recently [Bausch & Lomb \(BOL\)](#); each of which you should consider keeping in your casebook as most prospects likely owned at least one of these. Each of these Companies experienced very public un-doings, with the "cause" of said decline being revealed only after the stock was already undone. The reality of these collapses runs counter to the way most investors like to envision the stock market, which is as an efficient machine with information being equally shared and quickly incorporated into the price of a stock. What we find, however, is that the technicals very often foreshadow the coming demise of the fundamental picture in such extreme cases as those mentioned earlier. From time to time we like to provide new examples for you to use in prospecting campaigns. In the past we have focused these articles upon one individual stock. Today we illustrate with one stock the collapse of a group of stocks aptly dubbed the **Subprime mortgage lenders**.

For this Anatomy of a Collapse we will focus on New Century Financial Corp, which at its peak was one of the largest subprime mortgages lenders, originating roughly \$12.2 billion worth of such mortgages in the fourth quarter of 2006 alone. While "business" appeared to be going along quite nicely, shares of New Century, (which once trade under the symbol NEW on the NYSE but has since been delisted and is trading over-the-counter under the symbol [\[NEWC\]](#)) began telling a very different story. We know that there is one relationship that drives the price of any given stock, that is the battle between supply & demand. If there are more buyers willing to buy the stock at a particular price then there are sellers willing to sell, prices will rise. If, on the other hand, there are more sellers willing to sell stock at a particular price then there are buyers willing to buy, price must fall. If there are equal numbers of buyers and sellers willing to buy and sell at a certain price then the price will remain the same. It is that simple, and while the reasons an investor may add demand or add supply to the market may be many, the price simply reflects the aggregate of all decisions being made in the marketplace. In order to gain insight into which stocks are controlled by demand and which stocks are controlled by supply, you must look no further than the Point & Figure chart.

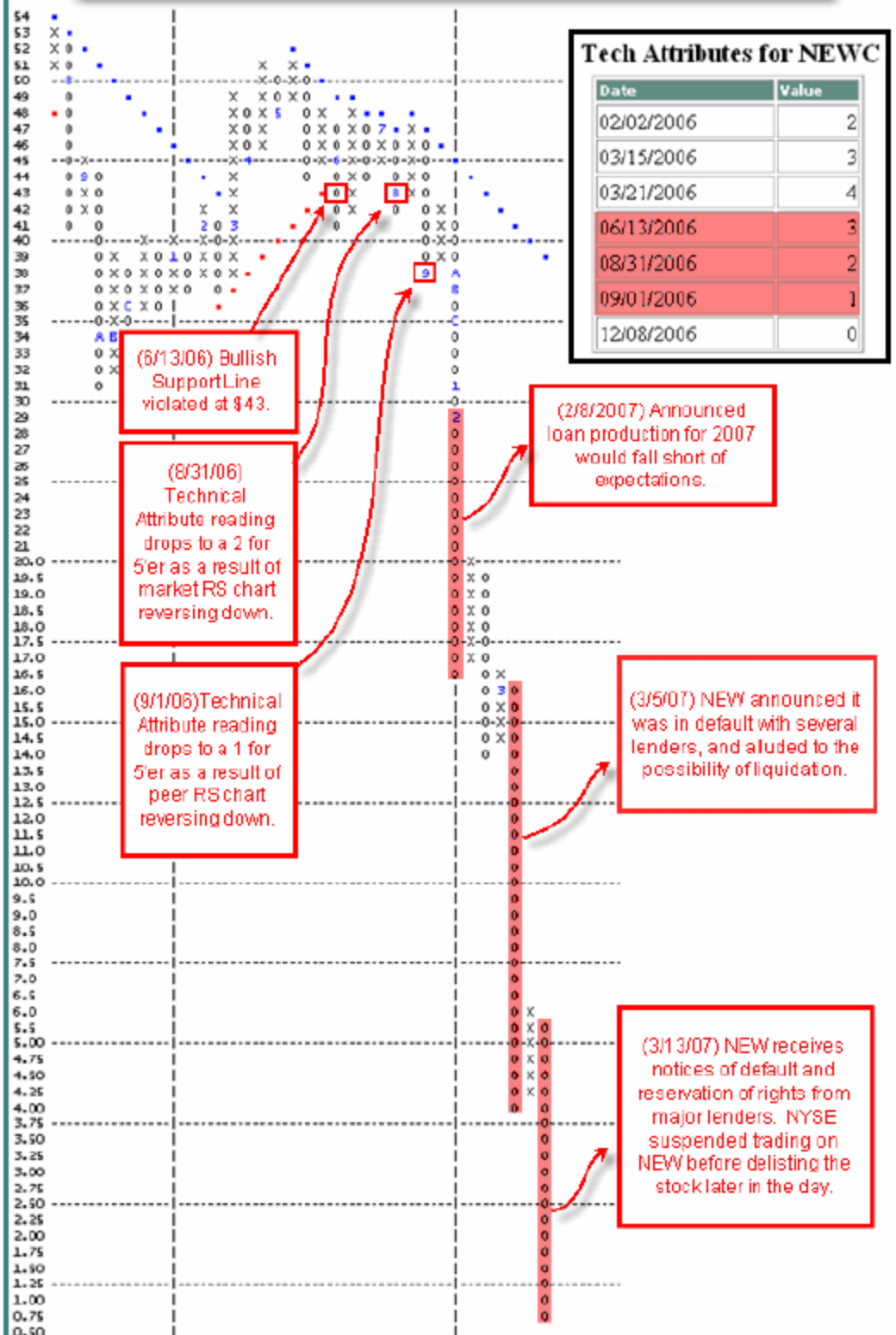
Let's start by looking at the Point & Figure chart of New Century Financial, which has been reproduced below. Notice that in June of 2006, this stock began to show signs of deterioration indicating that supply was taking control. On June 13th, 2006 shares of NEWC gave a double bottom sell signal violating the bullish support line causing the overall trend to shift from positive to negative. A mere two months later the relative strength chart of this stock versus the market reversed into a column of O's causing the positive technical attribute count to downtick below the "solid citizen" level as it fell to a 2 for 5'er. At this point, if the trend line violation was not enough to sell it was at least an indication that the odds were no longer stacked in NEWC's favor, and the probability for lower prices was much greater than the probability for higher prices. This drop in technical attributes occurred on 8/31/06, a day that NEWC closed at \$38.71. Certainly, this was roughly 40% off the chart highs back in 2004, but it was also nearly 97% above where the stock changes hands today at \$1.29. Eventually, in December of 2006 NEWC saw its technical attribute reading drop to 0 for 5'er status around \$35. At this point, this stock was in an overall negative trend with negative relative strength against the overall market as well as against its peer group. In other words, there was absolutely no reason on a technical basis to be long this stock. Recall that we consider only stocks with at least 3 positive technical attributes for long exposure. All told, the technicals provided a story of deterioration long before the dreadful news began to circulate publicly regarding subprime mortgage lenders.

The first large leg down for NEWC came on February 8, 2007. **The Dow Jones Market Watch** announced that:

"Shares of New Century Financial tumbled nearly 30%, and hit a near 4-year low in intraday trading, after the Irvine, Calif. mortgage products provider warned late-Wednesday that 2007 loan production would fall short of expectations. The company said it now expects 2007 loan production to be 20% below 2006 levels, vs. previous forecasts that it would be flat, as the level of early-payment defaults and loan repurchases have led to tighter underwriting guidelines. The company also said it would restate results for the quarters ending March 31 through Sept. 30 to correct accounting errors related to loan repurchase losses."

New Century then floundered around for the next few weeks until the improbable became closer to the possible when the company announced on March 5th of this year that it was in default with several of these lenders and alluded to the possibility of liquidation. A week later on March 13th New Century announced that it actually received notice of defaults and reservation of right from their major lenders. The NYSE went on to suspend trading before ultimately delisting this stock from the exchange on the same day, and causing the possible to become a harsh reality.

New Century Financial Corporation (NEWC)



Fundamentals can serve an important role to investors, it can answer the question of "What companies to invest in," but it does not answer the equally important question of "When to own their stock." As you can see from the table below (data courtesy of Dow Jones Market Watch), while not every firm on Wall Street was raving about shares of New Century Financial at every turn over the last few years, the recommendations were generally constructive and at times quite positive. We certainly did see fundamental downgrades come for this stock; however, many of them still left you with unabated exposure to this stock in particular, but to many of the other subprime mortgages lenders out there as well.

Fundamental Recommendations for New Century

**Data Source: Dow Jones Market Watch

Upgrades Updated: 11:46 am ET Mar 12

| Date | Symbol | Broker | New | Old | Comments |
|------------|---------------------|----------------|-------------------|----------------|-------------------------|
| 3/1/2007 | NEW | Bear Stearns | Peer Perform | Underperform | Broker cites valuation |
| 11/23/2005 | NEW | JMP Securities | Market Outperform | Market Perform | Sets \$48 price target. |

Downgrades Updated: 11:46 am ET Mar 12

| Date | Symbol | Broker | New | Old | Comments |
|------------|---------------------|-----------------|----------------|-------------------|--|
| 3/12/2007 | NEW | Piper Jaffray | Underperform | Market Perform | Broker cites belief that co. is unlikely to get new needed financing |
| 3/12/2007 | NEW | UBS | Reduce | Neutral | Price target cut to \$2.50 from \$17; broker cites belief that bankruptcy is likely |
| 2/8/2007 | NEW | Merrill Lynch | Sell | Neutral | Broker cites lack of clarity in outlook, and expectations of more bad news |
| 2/8/2007 | NEW | Jefferies & Co. | Hold | Buy | Price target cut to \$23 from \$48; broker cites risks to book value stemming from a restatement and increased credit risk |
| 10/16/2006 | NEW | Stifel Nicolaus | Sell | Hold | Says "party is over." |
| 9/8/2006 | NEW | Bear Stearns | Underperform | Peer Perform | Broker cites intensifying industry competition |
| 8/31/2006 | NEW | UBS | Reduce | Neutral | Price target cut to \$32 from \$45; broker cites increased risk of credit downturn |
| 6/14/2006 | NEW | JMP Securities | Market Perform | Market Outperform | Cites concerns over slow margin recovery |
| 10/31/2005 | NEW | Morgan Stanley | Equal-Weight | Overweight | Cuts price target to \$35 from \$58; cites concerns over persisting margin deterioration and housing market risk |

Interestingly enough, investors were invoking more selling pressure on this stock long before much of the news started to become public, but the real reason that this stock fell precipitously over the past few months is because there were simply more sellers willing to sell this stock than there were buyers willing to buy. While there were bounces along the way, the technicals never revealed a true picture of recovery from this stock. Quite possibly Jim Cramer said it best in an article written on March 8, 2007 titled, "What's Turning Subprime Around", the same day New Century opened trading at \$5.59.

I now agree with Tom Brown that the worst is over in the group and we are beginning to see survivors as the money pours into this sector from non-traditional sources. Remember, when you price something to move, even if it is loans that are on the precipice of default, you can come up with buyers. I know this positive spin flies in the face of much of what you have heard about this allegedly toxic business...

As we quickly found out, that theory flew over like a lead balloon. Interestingly enough, New Century was not the only one to show signs of deterioration back in the June to September time frame from last year. Notice on the table below a list shows five other of the subprime mortgages lenders (six including New Century). Despite the bounce these stocks have experienced in the past couple of days, there are still off considerably from the time their respective technical attribute reading dropped below the 3 positive threshold, and many are off even more since their trend line violation. For instance, Accredited Home Lenders [LEND] is among the leaders over the past couple of days as far as reflex rallies are concerned; however, this stock dropped down to a 2 for 5'er with respect to its positive technical attribute reading on 8/8/06. Since then this stock is down a dismal 74% while the S&P 500 Equal weighted index [SPXEW] is up 12.74% over that same time period. In other words, New Century was not the only subprime mortgage lender to fall victim.

Subprime Mortgages Lenders

| Symbol | Name | Recent Price | Tech Attrib | Date Uptrend Line Violated | Date Tech. Attrib dropped below 3 | Price when Tech Attrib reading dropped below 3 | % Change from date Tech Attrib dropped below 3 | SPXEWI return |
|--------|-------------------------|--------------|-------------|----------------------------|-----------------------------------|--|--|---------------|
| AHM | American Home Mortgage | \$ 25.63 | 1 | 8/10/2006 | 2/21/2007 | \$ 30.80 | -16.79% | -4.80% |
| LEND | Accredited Home Lenders | \$ 10.99 | 2 | 6/19/2006 | 8/8/2006 | \$ 42.28 | -74.01% | 12.74% |
| NDE | IndyMac Bancorp, Inc. | \$ 29.63 | 0 | 2/8/2007 | 1/16/2007 | \$ 40.50 | -26.84% | -1.05% |
| NEW | New Century Financial | \$ 1.29 | 0 | 6/13/2006 | 8/31/2006 | \$ 38.71 | -96.67% | 9.39% |
| NFI | Novastar Financial Inc | \$ 5.42 | 0 | 9/11/2006 | 6/8/2006 | \$ 30.12 | -82.01% | 11.79% |
| FMT | Fremont General Corp | \$ 7.37 | 1 | 6/22/2006 | 10/17/2005 | \$ 19.42 | -62.05% | 21.65% |

The beauty of the Point & Figure chart is that it has no preconceived bias, it doesn't care who owns the stock, likes the stock or just predicted the stock to double in the next 12 months. The chart only cares about the daily highs and lows of the stock price, and over time that tells an interesting story of its own.

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