

Lessons learned from the global financial crisis

Oliver's insights



Key points

- A range of factors lie behind the severity of the global financial crisis and its fall out over the last year: financial deregulation; the search for high yield based returns in ignorance of the risk; low interest rates earlier this decade; financial innovation; high debt levels; & of course, greed on the way up and fear on the way down.
- The key lessons for investors from the last year are: the investment cycle is alive and well; higher returns come with higher risk; the role of sentiment can never be ignored; be wary of financial engineering; be wary of gearing; and government bonds should always be included in a well diversified portfolio.

Introduction

The past 60 years has not seen anything like the freezing up of lending between global banks, the disruption to credit flows or the need for so many financial institutions in the US and Europe to be rescued as we have seen in 2008. The current crisis is not the worst in Asia (1997/98 was) or Australia (the early 1990s was). But for the world as a whole it is the worst financial crisis in the post war period. So how did it come to this? What will it mean going forward? What are the lessons for investors?

How did it come to this?

While many are looking for easy scapegoats to blame, the origins of the current malaise are multifaceted and include:

- **Financial deregulation.** Over the last 20 years this helped unleash much greater competition in the global financial system and hence the greater availability of debt. It ultimately led to a failure of US regulators to keep up with new financial products and growth in leverage. This is not to say deregulation was wrong, but in some countries, such as the US, it went too far.
- **The shift from high inflation to low inflation.** This saw interest rates fall, which was great, but it had the effect of encouraging borrowers to borrow more and drove investors to search for higher yields. This led them to greater allocations to investments such as listed property trusts and of course the complex securities at the heart of the current problem. This occurred without due regard for the extra risks involved.
- **Financial innovation.** Amongst other things this saw a massive expansion of the securitisation approach to debt financing. This is where a financial organisation (say a mortgage lender) "originates" a loan to a borrower (say a home owner). These loans are then sold to other organisations that package them up with lots of other loans into securities which are "distributed" to investors all around the world. The theory was that

by combining lots of loans the risk would be low. Ratings agencies provided high credit ratings (eg AAA) for securities whose underlying loans would normally be regarded as sub-investment grade. A problem with the "originate and distribute" model is that there was no "bank manager" looking after depositors funds.

- **The US housing boom.** These developments, spurred by low interest rates early this decade, came together to drive the US housing boom which was increasingly underpinned by a deterioration in lending standards. This saw a huge growth in loans to so-called sub-prime (or high risk) home borrowers in the US up until 2007.

The music stopped in 2006 when poor affordability and an oversupply of homes saw US house prices peak and then start to slide. This made it harder for sub-prime borrowers to refinance their loans in order to maintain their initial low "teaser" mortgage rates. As a result more and more borrowers defaulted causing investors in the fancy products that invested in sub-prime loans to start suffering losses in 2007 – and this became the sub-prime mortgage crisis. Rising unemployment and falling house prices have since seen the problem spread to all US mortgages.

But why did the sub-prime crisis drag down the whole world? Firstly, the extent of bad loans and hence losses has been far worse than thought. Secondly, record levels of debt in investment banks and hedge funds have accelerated the losses and the declines in key assets as positions had to be unwound to cut debt or meet redemptions. High household debt has also made the economic fallout far greater and this has seen the crisis spread to countries such as China. Thirdly, the distribution of securities investing in US sub-prime debt all around the world has led to a wider range of exposed investors and hence greater worries about which financial institutions are at risk. Fourthly, just as greed played a role on the way up, fear played a huge role on the way down. This is evident in the freezing up of lending between banks in the aftermath of Lehman Brothers failure on fears all banks are at risk or the dislocation in credit flows to good companies. These factors all came together to result in a downwards spiral of falling share markets, falling confidence, reduced lending, reduced economic activity, more losses, then more falls in share markets, etc. And this was all transmitted globally via trade flows, confidence effects and capital movements.

So fault lies with a range of players: the US home borrowers who weren't aware of what they were getting into, the lenders who relaxed their lending standards, the ratings agencies, investors chasing returns without regard to risk, US regulators, and financial organisations for taking

on too much risk. And, as always, greed and fear also played a big role in magnifying the boom and then the bust.

The end result was a year of extremes

The end result has been a year of extremes, including:

- One in 10 US households with a mortgage now behind in their payments or in foreclosure.
- The de facto demise of the big five US investment banks, via bankruptcy, merger or conversion to banks.
- The nationalisation of Fannie Mae and Freddie Mac, which own or guarantee half of US mortgages.
- The “closure” of 23 US banks, the rescue of Citigroup and public capital injections into many other banks.
- The need for numerous European banks to be supported by governments.
- The worst bear market in US shares since 1937 and the worst in Australian shares since 1973-74.
- The lowest level for ten year bond yields in the US since 1951 and in Australia since 1952 as investors sought their safety and on deflation worries.
- A blow-out in the US investment grade credit spreads to levels not seen since the 1930s.
- A 60% collapse in commodity prices since mid year.
- The most synchronised global down turn since WW2.
- And a 90% collapse in the cost of freight space on cargo ships, reflective of a collapse in global trade.

Was it forecastable?

Why didn't all the experts see it coming? This is a good question as most didn't and even those who saw problems didn't see it unfolding this quickly. There are several points to note. For one thing, if most of the experts had seen it coming then the boom that proceeded it wouldn't have happened in the first place so nor would have the crash. Secondly, there is an important distinction between something that is foreseeable (eg “eventually high debt levels will cause a problem”) and something that is forecastable (eg “high debt levels will cause a major problem in 2008”). While some sort of financial crisis made worse by high debt levels and global savings imbalances was foreseeable, it was not forecastable in the sense of being able to accurately predict its timing.

Some did get it right over the last year, but as former RBA Governor Ian Macfarlane observed “Everyone who predicted what has happened this year has been predicting it for 10 years”. And that's not a great track record. There is no guru or expert who will get it right all of the time.

The post meltdown world – how different will it look?

It's hard to see the events of the last year or so not having major implications. We see several:

- **Increased regulation of the financial sector.** The damage caused by the financial crisis will lead to a rise in regulatory oversight of the financial sector globally.
- **Bigger government.** This is already apparent with various governments taking stakes in financial institutions. A big increase in public infrastructure spending is on the way in China, the US, Australia etc.
- **Back to basics investing.** Given the problems sophisticated investment products have had and the rise in investor scepticism, we may see a return to simpler investment products with less reliance on financial engineering, leverage or claims of positive returns in all environments. We may well see a “back to basics” world re-focussed on shares, government

bonds, cash and direct property/infrastructure with less reliance on in-between assets.

- **Slower growth in the financial sector.** The crisis along with greater investor scepticism and more regulation is likely to slow the rate of growth in the financial sector after 25 years of above average growth.
- **A faster shift in economic power to Asia.** The global financial crisis is likely to have accelerated the shift in relative economic power from the G7 countries, which have now suffered a loss of global credibility and are likely to be hampered by excessive debt (especially in the case of the US), to Asia which has high savings and has not seen its banking system come under threat. This will likely be reflected in a favourable relative performance of Asian assets going forward.

What are the lessons for investors?

The past year or so highlights several lessons for investors:

- **The business cycle is alive and well and hence so too is the investment cycle** which has reminded us yet again that periods of great returns are invariably followed by a fall back such that long term returns are more consistent with underlying economic growth. If returns are too good to be true they probably are.
- **High returns always come with high risk.** While risk is often dormant for years it usually returns with a vengeance as is now apparent. The trick for investors is to be aware of the extra risk they are taking on.
- **Sentiment plays a huge role not just in investment markets but also in the global financial system and economy.** This has been amply demonstrated over the last year. While trading against the crowd hasn't worked too well over the last year, history demonstrates that the crowd always pushes to extremes and successful long term investors do the opposite.
- **Be sceptical of financial engineering or hard to understand products.** The biggest losses for investors in all this have generally been in products that rely heavily on financial engineering. Such constructs often have a poor alignment of interests, poorly understood risks and fees may be excessive.
- **Avoid too much gearing or gearing of the wrong sort.** Gearing is fine when all is going well. But it will magnify losses when things reverse and can force the closure of positions at a big loss when the lenders lose their confidence and refuse to roll over maturing debt or when a margin call occurs in the case of margin debt.
- **The importance of diversification and government bonds.** While listed property and hedge funds have been seen as an alternative to stodgy low yielding government bonds, over the last year the former have both run into big trouble and been shown to be correlated to equities, whereas government bonds have been star performers. Related to this investors need to be a lot more sceptical of claims by hedge funds that they will provide positive returns in all environments with risk not that much above that of bonds.
- Finally the wild daily and weekly gyrations in markets over the last year highlight the difficulty for most investors in timing short term moves and reminds us the best approach is to focus on a long term strategy.

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