



Strategy Overview Interim Paper

The Crash of 2007/08

11-12 Bury Street
London EC3A 5AT

Telephone: +44 (0)20 7283 0671
Fax: +44 (0)20 7444 4371

Web: www.mips.co.uk

Meridian Investment Consultancy

Interim Strategy Overview

The Crash of 2007/08

It's much too soon to call it that, of course, but it's our view that the turmoil in bond and equity markets in the summer of 2007 is the precursor to many more problems for investors and for insurers.

Background

The origins of the recent volatility go back two or three years, and start with the very high level of liquidity in the global banking system. This in turn has two main causes. The first is the US Federal Reserve's decision to cut their base rate to 1% in the aftermath of the technology crash. The second is the huge US budget deficit, which has led to a huge trade deficit. The end result became a system awash with money looking for a home.

Over the last three years the result has been a huge reduction in credit spreads, as investors looked further down the credit quality curve for extra yield. Our first real warning of trouble ahead came in October 2006, at a presentation by a large UK property unit trust, with a portfolio of over £2 billion of top quality commercial property. They'd decided they could use an additional bank loan facility, and asked 10 major UK-based banks to quote terms for a facility of £100 million. The fund had no other significant borrowings. There was a time when banks would have fallen over themselves to bid for such business. Not this time. Only three banks were prepared to discuss terms. The response from the other seven was almost identical: "We can't quote, it's not risky enough". They couldn't charge enough to make the loan profitable.

That rang a very loud warning bell. Then at the start of 2007 it became apparent that a very similar problem had been building up in the US mortgage market. In order to make reasonable profits lenders had been loosening terms and making loans without any proof of income to people who were beginning to default in large numbers. Six months ago it was clear that these sub-prime loans were a problem, but in most cases the original lenders didn't care that much, because they'd repackaged the loans and sold them on to other investors. Often the loan had then been repackaged again, used as backing for asset-backed bonds, collateralised debt obligations, and so on. After the second or third layer of packaging it was very difficult for an investor to find out what their real underlying collateral was, but the bonds paid a good yield over US Treasuries, and the rating agencies said they were AAA quality. This may sound a little like the old Christmas party game of pass the parcel, but lots of these parcels didn't have any goodies inside.

The next bell was rung in June, when Bear Stearns, a large investor in these structured loans, had to close two hedge funds which had invested in securities backed (ultimately) by sub-prime mortgages, because they'd discovered that the bonds were worth a lot less than they had thought. That triggered a panic which is still running.

The main difficulty that Bear Stearns had was that most of the bonds they had bought never traded, so they were valued on the basis of a computer model. This turned out to be over-optimistic. Then all the other investors in asset-backed bonds

got nervous too, and started to worry if their computer models were over-optimistic. The natural result was a flood of sellers deciding to reduce their exposure to the asset class.

The next problem was that many investors in these assets were using borrowed money. In the case of two German banks they were borrowing that money through the short-term commercial paper market. In mid-August both found that they could no longer borrow, as lenders decided they were too risky. About €30 billion has since been needed to prop up those banks, and there will no doubt be a long list of others to follow. Because so much of the money invested in collateralised bonds has been borrowed (but may not be borrowable next week) there is a lot of pressure to sell in these markets, and very few brave souls prepared to buy these bonds.

All this creates a great deal of uncertainty. People holding bonds won't always know what they are worth, and those holding structured securities backed by lower quality credit will have a big problem. Banks who have lent to these investors won't know who is in trouble until a lot of research has been done.

Banks also don't know which other banks may be in difficulty, so they have already started to restrict who they lend to in the inter-bank market. As liquidity dries up some banks will find that they have to go to their central bank for support. There is no guarantee the central bank will help, unless the troubled bank can demonstrate it can survive.

Next Steps

So what happens next? There has been talk of central bank intervention, and indeed the Fed has taken a first step in that direction. The difficulty is that the problem may be bigger than the central banks can easily handle. They can cut rates, and push lots more liquidity into the market, but that's just what caused the problem in the first place.

So intervention is likely to be concentrated on supporting major banks, and accepting that there will be bank failures. This is not ideal, but central banks don't have the muscle to save all those banks who may get into trouble.

At this stage it's far too soon to say what the total losses from the sub-prime mortgage debacle will be, but estimates run as high as \$100 billion. US house prices are falling, and sales have dropped to the lowest level in twenty years.

One of the side-effects of the original problem has been the withdrawal of lending for equity buy-outs. Almost all private equity deals and other buyouts have depended heavily on borrowed money. All of a sudden that's no longer available, leaving some deals in mid-air. It's unlikely that lending will become available again for some time. This removes an essential prop from the equity market, which had begun to value shares on the basis of what a bidder would pay.

This is the really big unknown for the next year. Sub-prime mortgages are probably just the tip of a large iceberg. Poor lending to sub-prime borrowers was driven by banks who had to find places to lend all the money they had. This was made easier because they could then pass on those loans to investors by repackaging them (sometimes in obscure ways) and selling them on.

It would be foolish to think that sub-prime loans are the only bad loans banks have made. The flood of liquidity we keep referring to will have pushed them into making lots of loans to low-quality borrowers, and there are certain to be more defaults from

other areas. The prime candidate will be loans for leveraged buyouts and private equity deals. These markets are bigger than the sub-prime market, and we should expect that losses will be bigger.

The banks have an additional problem with leveraged buyouts. Most LBOs are set up on the basis that banks guarantee the funding, but this is then replaced with bond issues as soon as possible. At present it is estimated that banks have committed \$400 billion or more to LBOs, which they expected would be refinanced almost immediately. Unfortunately the bond markets will not currently accept the necessary bond issues, so the banks will actually have to extend loans for a longer period than they expected. Finding the cash should not be a problem, but the banks had not planned to have these loans on their books for more than a few days. The loans will now take much longer to refinance. Some of these loans will be of low quality, and they will be the most difficult to refinance.

It's very hard to estimate what the total size of the bad debt problem could be over the next two years. If sub-prime alone could cost \$100 billion then it's hard to see how the total cost of bad loans could be less than \$500 billion. That's a big number.

Insurance Implications

This is going to cost the insurance industry a lot of money. Already bond investors are suing banks who had sold them bonds based on sub-prime mortgages. The ratings agencies are bound to be on the hit-list as well. Given the potential size of losses this could turn into a bigger catastrophe than the 2005 hurricanes.

Having said that we doubt whether reinsurers have yet appreciated the likely cost, and reinsurance at almost any price would probably be a far better investment than US Treasury bonds.

We'd recommend all our readers to make very pessimistic assumptions about claims on financial institutions of all sorts. Reserving up to policy limits will probably be essential, if the losses are as big as we fear. It's also worth pointing out that these will be claims from multiple events, unlike most disaster scenarios. Multiple reinstatements will be needed.

Credit Ratings

One of the key problems to come out of the sub-prime debacle has been the behaviour of the rating agencies. All the bonds which were backed by repackaged mortgages had ratings, and the ratings agencies were often actively involved in helping to structure bonds to achieve the desired ratings. Now the agencies are downgrading some AAA bonds straight to junk, and downgrades of three to six notches are not uncommon.

The agencies are being accused of incompetence, and of conflict of interest. These will be hard charges to defend. The underlying problem is that the agencies used complicated models to derive their ratings, and those models were based on relatively short periods of data. The last four years have been benign for all types of credit, and as a result it's fair to assume that the models were over-optimistic.

The same models have been used for other asset-backed bonds, based on generic corporate debt, leveraged loans, and so on. It's certain that a lot of collateralised debt obligations and collateralised loan obligations will suffer defaults in their underlying collateral over the next two or three years. The problem for investors will

be finding out what the underlying collateral actually is. A lot of these bonds have used other collateralised bonds as their own collateral, so the underlying collateral may be three or four layers down in a structure. This is one reason it took six months for the original sub-prime problems to surface in the CDO market.

So the credit rating agencies will take a severe knock to their reputations (probably no bad thing), and investors will be much more cynical about the value they put on formal ratings. Our view is that any investor taking credit risk in today's markets must have an investment manager with deep internal expertise of credit analysis. Relying on external credit ratings will not be good enough while we go through the credit failures of the next two or three years.

One of our biggest concerns is that most AA rated corporate borrowers are financial institutions. Some of those banks are going to have liquidity problems and bad debts which will threaten their survival.

Bond Markets

The immediate effect so far has been a flight to quality. Investors have sold corporate bonds to invest in government bonds. As a result credit spreads have widened, but are still a long way below the levels seen in 2002 and 2003. Banks and other financial stocks have suffered badly.

Spreads are likely to widen a lot more. We've had no failures yet to hit bonds directly, but when banks do get into trouble then sellers will panic. We recommend great caution in the corporate bond market, and at present we'd remove all exposure to bonds below A- ratings.

The natural reaction of central banks will be to cut interest rates, but that's a tool that can only be used once, and they will delay for as long as possible, until they can see just how bad the problem is. The main problem at present is not the cost of lending, but the availability. Central banks can reduce the cost, but they can't force banks to lend.

At present we'd guess (and it is no more than that) that rates could hit a low in 2009, mainly because we expect it will take that long for the credit crunch to work its way through the system. That suggests that duration should be increased now, even after the sharp rise in Treasury prices, but that managers should be encouraged to be more active in trading either side of the neutral duration position.

Equity Markets

Equities are one of the most volatile asset classes. Prices halved after the technology boom, and then doubled from 2003 to 2007 back to previous peaks. Some wild optimists are saying that we've had the bear market, and that equities will soon begin to rise again. There's never been a bear market that brief. Bear markets typically last for two or three years, and will show falls of 25% to 50% below previous peaks.

It's been famously said that nobody rings a bell at the top (or the bottom) of the market. You only know when bull market turns to bear a year or two later. Our view is very strongly that the difficulties in credit markets will start to have a big impact on equities. Companies which have large short-term borrowings will find it more difficult and more expensive to renew their loans, and there will be bankruptcies.

Consumers will lose confidence, save more and borrow less, and will spend less.

There is not much sign of this yet, but it will happen.

Hedge Funds

Hedge funds scare people much more than they should. This is, in part, because the press only pick on bad news stories about hedge funds. It is also because hedge funds are deliberately secretive. The facts still are that hedge funds are far less volatile than equities, and heavily focused on not losing money. Current estimates for August 2007 are that hedge funds on average will have lost about 2%. That will conceal a very wide range of results, which is why diversification and professional management of hedge fund portfolios are paramount.

At the same time several hedge funds have either closed down, or stopped redemptions, while they value their portfolios of structured securities. There are several "hedge funds" which appear to have borrowed money to invest in structured bonds, and to have little protection for their downside risk. None of our clients have suffered from these problems, but this does emphasise the need to use a professional manager if investing in hedge funds.

Some funds (the Paulson group in particular) have made spectacular amounts of money from the sub-prime problems. This is, in our view, one of the key arguments in favour of hedge funds. Well-managed funds can make as much money in falling markets as they can in rising ones. Yes, you need to be selective, and avoid funds with nett long exposures to equities, for instance, but on balance hedge funds made money from 2000 to 2003 when equity markets fell by 50%.

Emerging Markets

The last four years have been amazingly successful for many emerging economies. Many have raised their credit ratings well above the junk level, and their stock markets have been flying. Can this continue in the face of a serious slowdown in the US economy (and probably the UK and Europe as well)? Almost certainly not. There have been two big positives for emerging economies over the last four years. The first is the dramatic rise in the price of raw materials, most of which come from emerging economies, rather than developed ones. The second has been the rapid growth of Chinese (and Indian, to a lesser extent) exports. The Chinese economy has been growing by 8-10% a year, mostly driven by exports. Quality concerns, and product recalls of toys, clothing and other products are probably taking the shine off that boom now, and consumers will be more wary of Chinese-made goods.

As a result we'd expect emerging market debt and equity markets to suffer along with everyone else. They will not be a safe haven.

Summary

Sub-prime is the tip of an iceberg. It may be 10% of the problem, or more, or less. All we can be sure of is that there will be more bankruptcies and defaults over the next two or three years as the bad and careless lending of the last two or three years works its way through the system.

What should insurers do with their investments? Some answers are easy:

- Raise credit quality. This is partly a function of which manager you use, but we'd want to ask managers to explain explicitly how they'd handle the sort of downgrades and failures that we expect to happen. If in doubt cut

exposure to BBB and A rated bonds sharply (or completely).

- Reduce exposure to financial institutions. Investment managers have tended recently to invest heavily in corporate bonds issued by banks and other financial intermediaries. These now look threatened by all the risks we've outlined above. We'd suggest halving your current credit exposure to financial institutions. If you're a real pessimist you might want to cut it entirely. Investing in government bonds instead will reduce your yield, but it will guarantee you get your money back.
- Sell equities. The equity market won't be able to stand up to the sort of bad news we expect over the next two years.
- Hold hedge funds, and possibly use them as a home for money coming out of equities. The key points in hedge funds will be to have a professional manager in charge of the portfolio, and to be well diversified.

If your underwriting is exposed to claims from financial institutions do some pessimistic modelling and then grit your teeth and buy more reinsurance. Buy additional reinstatements on existing reinsurance cover, if you can, this will be lots of separate events, not a single catastrophe.

Check your ICA calculations. Markets have become very much more volatile. You will probably need more regulatory capital to set against your investment portfolio.

Next Steps

This is a complex subject, and not easy to explain in a short paper. We plan to hold an investment seminar at the end of September to discuss these issues in more detail, and to allow a full discussion of their likely effects. These seminars are provisionally arranged for 2 pm on 27th September and 10 am on 28th September. Please call Colleen Briggs on 020 7283 0671 to book places. These seminars are free to our retainer clients, and £250 each to non-retainer clients.

And, of course, we're always available for individual discussions, except that I'll be at the Old Bailey for two weeks from September 10th. In the jury room, fortunately.

David Osborne

31 August 2007

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