



# Strategy Overview

## The Crash of 2007/08 Act 1 Scene 3

Exit Goldilocks, pursued by Bears

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# Meridian Investment Consultancy

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### The Crash of 2007/08: Act 1 Scene 3

Economists and financial commentators like to refer to “the Goldilocks scenario”. This is when the economy is not too hot, and not too cold, but “just right”, as porridge should be. After the turmoil of the 1970s and 1980s the last 15 years have mostly been rather like that, with occasional problems like the tech crash, and occasional blips in interest rates, but mostly with low inflation, steady growth, and a quiet life.

That is, for most of us, the way we like things to be. All asset classes behave in a fairly predictable way, so estimated investment income comes out right on target, currencies are stable, and so on. It’s probably why there are so many economists who love to predict a soft landing when things get a bit more sticky. Unfortunately it doesn’t always turn out so well.

Our view at present (and we may be wrong) is that the present credit crunch is a more severe problem for the global financial system than any we’ve seen in the last 15 years. The world will survive, and later in 2008, or possibly 2009, there will be some good opportunities for bond and equity investors. But between now and then there will be some pain, and there’s not much to be lost by being careful for a few months. Our last two papers on this subject, still to be found on our website at <http://www.mips.co.uk/doc/Crash1.pdf>, and <http://www.mips.co.uk/doc/Crash2.pdf> for Act 1 scene 2, covered the question of asset allocation and risk reduction in more detail.

This paper is more of an update on what’s happening now we’re in 2008.

#### ***Contagion - Property***

When the sub-prime issue first surfaced in early summer there were some who thought that it was the only issue. As you’ll know we saw it as just the first part of a much more deep-rooted problem, which was the very careless lending practices of most banks over the last few years. We assumed that there were many more problems out there, and it was just a matter of time before other strains started to appear.

In the UK those strains have appeared in a slightly unexpected area, commercial property. One of the attractions of commercial property as a direct investment is that nothing happens very fast. Valuations and asset values move up (and sometimes down) quite slowly, so volatility is low, and there are few surprises.

Now the surprises have come. Almost all the UK property unit trusts (PUTs) investing directly in UK commercial property have fallen very sharply in price during the last two months, and several have completely closed their doors to redemptions, saying that they will need to sell to raise money, and that unit-holders may have to wait for twelve months or more to get their money back (and then perhaps not all of it). Prices seem to have fallen by about 10% in three months, but locked-in investors may well see bigger losses than that.

In December New Star, who have one of the largest funds aimed at the UK retail market, marked the NAV of that fund down by 17.8%.

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Here's a chart showing the price of a Halifax property unit trust for 2007:



The UK commercial property market had an amazingly good four years up to the first half of 2007, but this was helped along by large borrowings, some fairly short-term. Banks are no longer lending or extending existing loans, in many cases, and a degree of panic has crept in. If prices give up half of the increase from 2002 then they could well fall another 20%, at which point some bank loans will be uncovered.

This makes it rather surprising that UK house prices haven't fallen yet. They are two entirely separate markets, but it is clear that house loans are much more difficult to get, and that the very top end of the market in London will be affected by lower bonuses from the City. The first half of 2008 may be more difficult, volumes tend to be lower in the fourth quarter of the year anyway.

### **Contagion – Money Market Funds**

AAA-rated money market funds have become very useful vehicles for managing short-term liquidity. Most insurers and syndicates use them, and most assume that they are virtually risk-free. Indeed, most of the time they are, but these are not normal times.

We had a call from an investment manager at the end of November which caused us some concern, and which is worth passing on.

Almost all AAA-rated money funds trade at a fixed price of par (100). In practice the underlying net asset varies every day, usually in a very narrow band either side of par. The rules under which these funds operate will allow them to continue to trade at par as long as the NAV is within a range of 99.5 to 100.5. If the price moves outside that range then the price must be adjusted to match the actual NAV, and the fund loses its AAA rating. At that point, of course, everyone wants their money back.

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In December, Bank of America announced the closure of a US \$ money market fund, after the NAV fell to 99.4%. We are aware of another UK-based fund which has suffered the same fate.

As a result of this process all money funds have drastic processes in place to make sure they don't "break the buck", but it's equally clear that these may be coming under some strain. Certainly the manager who called us in November was looking at a NAV of around 99.80, which is well above disaster level, but already in a zone where drastic action might become necessary. The big threat is of cash outflows which shrink the fund. If you're paying out at 100 when the actual NAV is 99.8 then the NAV will start to fall, and the problem gets worse.

The other concern we have comes from the asset-backed commercial paper (ABCP) market. ABCP was the favourite way of funding most of the vehicles that banks used to get risky paper off their balance sheets. The special investment vehicles they created made the classic mistake of lending long, and borrowing short (15-90 days) in the commercial paper market. That commercial paper was bought by money market funds, and by others keen to buy short-dated and high quality paper. But for the last three months the ABCP market has been shrinking, and has now fallen in size by a third as investors have allowed paper to mature and then reinvested elsewhere, often in Treasury bills. The problem is so bad now that many of the remaining borrowers in the ABCP market have told their investors that they can't repay at maturity, and that the investors will have to roll over the maturity for another 90 days. We believe it is probable that at least a quarter of the ABCP market is now in forced roll-over.

As a result the NAVs calculated by money market funds may be misleading, because the funds are holding paper which they can't redeem.

This could have been a particular concern for Lloyd's syndicates who use the Citibank sweeps for their LDTF and situs funds. These sweep funds are managed by a third-party investment manager, not owned by Citibank. Fortunately Lloyd's and the managers were discussing this issue in December, and considerable comfort has now been provided. Letters of credit now back up the least secure investments, and the banks have agreed to stand behind others. It's still surprising that over 40% of the LDTF liquidity fund was still invested in securities backed by structured products.

### **Contagion – Banks**

This brings us on to a major problem. The big banks thought that the creation of structured products had shifted all the risk of the low-quality loans they were making onto third parties. They've now realised that they can stick by that view, and wash their hands of those loans, but that their reputations will suffer if they do. That reputational risk has persuaded those banks who think they can afford it to stand behind the structured securities they'd sold off. Unfortunately this brings all the potential losses and risks back on their balance sheets, and bank regulators are now asking whether the banks have enough capital to back these risks. The answer for some will be a resounding "no".

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***Contagion – Bond Insurers***

MBIA, AMBAC and five smaller insurers (referred to as monolines by the press) are specialist insurers writing financial guarantee business. They typically have AAA ratings, and this gives AAA ratings to the bonds they guarantee. Billions of dollars of issues in the US carry these guarantees, and they have also been used in the UK by private finance initiative borrowers.

Not surprisingly some of the bonds the monolines have guaranteed have turned out to be rather shaky, and as a result the rating agencies are examining whether the AAA ratings are still justified. The monolines may well need to find additional capital, and/or buy additional guarantees themselves from other AAA rated insurers. The problem, yet again, is that nobody knows what losses may come from the guarantees already in place, so nobody is keen to prop up these specialists. The companies also operate on a very high gearing. MBIA has underwritten bonds with a face value of over \$1 trillion, on a claims-paying ability of \$14 billion. That's a ratio of 1.4%, which many insurers might envy, but only if they expected very few claims. In December 2007 MBIA announced plans to raise a further \$1 billion of capital, which will help, but not much. At the end of December a small monoline was downgraded to CCC, and MBIA revealed additional exposure to CDOs and to CDO squared.

MBI alone insures over 15,000 bond issues, many of which are US municipals, but with a substantial element of conventional asset-backed and other bonds.

Bonds with these guarantees are quite common in insurance portfolios, and are beginning to be reconsidered on their own merits (which may be limited) in case the guarantees cannot be enforced in full.

What proportion of your portfolio relies on third-party guarantees for its rating? Do you know?

***Losses – Local Authorities***

One of the questions everyone has been asking is where all the losses have actually gone, because the numbers announced by big banks and others don't come close to the estimates. At the end of November new owners of dodgy paper turned up in local authority investment pools.

One of the first was a small community on the north of Norway, which couldn't pay its dustmen because they'd invested all their liquid assets in a fund which had, in turn, invested in structured bonds. The bonds aren't worthless, but the fund is closed while the managers try and work out what's left.

The state of Florida runs a liquidity fund for local townships, school districts and so on. Once as big as \$27 billion the fund has seen withdrawals of \$13 billion. The fund has now closed the door while it works out what losses it has run up on its portfolio. Orange County California famously went bankrupt in 1994, after making a bad bet on the direction of interest rates. Guess what? They are holding \$837 million of suspect structured products.

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***Downgrades***

In 2006 the rating agencies downgraded just over 2,500 bonds. In 2007 it was 20,000 and still counting.

***Alternative Scenarios***

When we published our first “Crash of 2007/08” paper back in August (a week before the run on Northern Rock) a number of investment managers suggested that we were being far too gloomy. Four months later we still feel gloomy. New announcements of “unexpected” losses from CDOs, new credit exposure, and so on, appear every day in the Financial Times. We still think that there are much bigger losses still to be discovered.

However, the equity markets in the US and UK have held up remarkably well, so there are still some optimists out there. To be an optimist you need to believe that central banks will continue to lower their rates, and (more importantly) that those lower rates will actually affect the rates at which banks are lending money. You also need to think that the US economy, and other developed economies, is not slowing seriously. There are those who think that growth in China and the rest of the developing world can make up for any slowing in the developed world. We don't believe that.

Others are encouraged by the willingness of the new sovereign wealth funds, full of oil money, and export surpluses from China, to provide new capital to western banks. It's an odd sight, isn't it, to see a Communist country helping to rescue the capitalist banking system?

There is always the possibility that we are wrong, and that the credit crunch will get no worse, that economies will continue to grow, and that everything is just fine, really. We think the chances of the Goldilocks scenario being correct for 2008 are about 10%, and that in the 90% scenario the banks and others keep discovering new losses. It doesn't cost very much at present to be conservative. You may give up some extra yield on corporate bonds. You may miss the excitement of the equity market going up by 20% in 2008. We're prepared to take the conservative option now, and like all good pundits, we'll be prepared to change our minds when the evidence says we should. But not until then.

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**Summary**

We are concentrating in these reviews on the bad news, because for bond investors bad news is really all that matters. Good news just means that your interest and principal will be paid on time. Bad news is anything which threatens that certainty, and by that definition there is plenty of bad news about.

We still see an equity market which is resolutely seeing these financial issues as a reason for central banks to cut interest rates, and see those cuts as unalloyed good news for company profits. That seems very strange.

**Checklist**

Do you hold any bonds which are guaranteed by one of the specialist insurers (“Monolines”)?

If you use any AAA money market funds will the managers tell you the current NAV, and what is the lowest NAV for the last six months? What proportion of the fund is invested in securities backed by structured products?

Are you taking too much risk in today’s more volatile markets?

David Osborne

7 January 2008

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