

Strategy Overview

The Crash of 2007/09 Act 3 Scene 1

The Bezzle Arrives

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Here Comes the Bezzle

John Maynard Keynes must be one of the best known economists there has ever been. Apart from being famous he was also quite a revolutionary in his thinking, and he was a very successful manager of investments, making Kings College Cambridge one of the richest of Oxbridge colleges.

One of his less well-known insights was that frauds tend to be discovered when economic times are hard, not when everything is going well. As part of this insight he invented the concept of the “bezzle”. This is the amount of money which has been embezzled, but where the fraud has not yet been discovered. The bezzle grows in good times, when people are a little sloppy with money, and then shrinks in bad times when people start asking for their money back.

On Thursday 11 December the bezzle shrank by a record-breaking amount. Bernie Madoff was arrested by the FBI after confessing to a fraud which may have lost investors \$50 billion. It'll be a while before we know the real damage he's done, but part of the losses will go to certain hedge fund groups who had invested very large sums with Mr Madoff, who ran a group of companies which included market makers and investment managers.

You'll remember the frauds discovered in the last recession, which included Enron and Parmalat. Madoff seems to be larger by an order of magnitude.

We can be pretty sure, given the nature of the bubble which went before the present crash, that the bezzle will shrink some more in 2009, as more frauds are uncovered.

Looking Forward to 2009?

Deciding on investment strategy in recessions and bear markets is a bit like driving along an unknown road in thick fog, and then you find yourself going down an increasingly steep hill. If you stray off the road you may fall off the edge, or hit a cliff. You know the bottom of the hill must be down there somewhere, but you don't know how far it is, and the brakes aren't working very well. Road signs flash past, mostly too fast to be read, and some seem to be in a strange language.

That's the problem we all face in 2009. We assume that the recession will end either this year or next, and that equity markets and credit spreads will begin to look better before the recession ends. But for the next six months at least, and probably twelve, we'll have conflicting economic data to contend with. By the time we're quite sure the recession is over it'll be far too late to take advantage of record credit spreads and collapsed equity markets.

So how do you (and we) try to steer through the economic fog? Odd as it may seem, not by taking too much notice of economics (do I hear a sigh of relief?). Economic data for the next year will be confused and confusing. Different interpreters will put their own spin on what's happening, but there can't be a consensus.

What we shall be watching and listening to are the markets, and the people who deal in them. Markets are moved much more by psychology than by economics, at least in confusing times like 2009. Back in 1841 a wise man called Charles Mackay wrote a book

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called “Memoirs of Extraordinary Popular Delusions and the Madness of Crowds”. There’s much more information at:

http://en.wikipedia.org/wiki/Extraordinary_Popular_Delusions_and_the_Madness_of_Crowds

The book is still in print, and as it is out of copyright electronic copies can be downloaded free, although it is also still available as a real book.

Mackay covered several stock market bubbles, going back to the original South Sea Bubble, and also Tulipmania. He was probably one of the first people to realise how easy it is to convince people that they can get rich quick. We can all still remember the technology boom/bubble, and we’re now living through the aftermath of the banking bubble. Mackay was probably one of the first to realise that these aren’t really economic phenomena; they are a reflection of human nature. Psychology hadn’t been invented in 1841, but Mackay would have recognised the concepts all too well. This is probably why some of the best investment managers I’ve known had degrees in psychology, not economics.

People-watching

So in 2009 we shall be studying people, not economics. People, and the way they behave, can give very good insights into the current state of investment markets. In particular we look for people who behave in non-intuitive ways. Equity examples are probably clearer:

Consider Company A, which makes an announcement of its annual profits, which are 20% higher than the market consensus had forecast, and with an optimistic statement about the future. Over the next week the shares fall by 20%. How can that make sense? Only by assuming that people were really expecting even higher profits, and were disappointed. It’s a pretty good rule that when the majority of companies see their share prices fall after a very positive statement then the bull market is over.

The opposite is also true. When share prices rise on the announcement of bad news then the end of the bear market is close. In bond markets, which are mostly concerned with interest rates and (especially now) credit ratings, there are similar rules. If bond prices fall after an interest rate cut then people were disappointed. It doesn’t matter what the forecasts were, the cut wasn’t big enough.

This is allied with people having problems looking beyond the first big problem. After the big global banks were bailed out in October we saw credit spreads fall a long way very fast. The news (in a sense) had just got better, the banks weren’t going to fail, and before long they might start lending again. So good news was followed by falls in corporate bond prices. Why? Because people had been concentrating so much on how the banks could be saved they had entirely ignored what was going wrong in the real economy. Once the banks were saved people started looking for the next problem, and realised that the recession which had already started was doing enormous damage to company profits and balance sheets. Investors aren’t very good at looking beyond the next big event.

In summary this is: “don’t listen to what I say, look at what I do”. And in 2009 that’s particularly important, because the economic data will be mostly bad, and often confused. It’s the way that investors react which will help drive our strategy in 2009.

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Strategy for 2009

We've written about this before, but now 2009 is here what should insurers be doing. Leave aside the question of when they should do it, the answer to that question is mostly "not yet". Better to spend time now adjusting the mind-set, and the investment guidelines, to the circumstances we now face. Let's look at the major influences.

How did we get here?

The financial crisis of 2007 & 2008 has its roots in the US housing market and in particular the sub-prime mortgage market. Since the beginning of the housing downturn US home prices have fallen around 20% on a national basis. As 2008 closes affordability has improved and supply has been cut back but these positive factors look to be offset by increasing foreclosures and rising unemployment. Still, it looks like the worst may be over in the US housing market.

The problems in the US mortgage market triggered problems for mortgage securities with knock on effects throughout the securities markets, and all gathered pace throughout 2008 leading to the cathartic event of the year – the collapse of Lehman Brothers.

Since the collapse of Lehman Brothers in mid September financial markets have gone into shock, liquidity has declined substantially and all financial markets other than government bonds have declined. Investment grade credit markets, which have been declining since mid 2007, now trade at spreads to governments never seen before. The FTSE 100 equity index has declined by 20% since the collapse of Lehman and is down by approximately 40% in 2008, with all other major equity markets down similar amounts.

The policy response has been equally extraordinary. Central banks in the major economies have massively increased the provision of liquidity to markets and have cut interest rates dramatically with the prospect that official rates will be cut to zero in 2009. Governments have underwritten new capital in banks, are guaranteeing bank bond issues and are effectively insuring all bank deposits.

Where does this leave us? Firstly, the balance sheets of banks and many other financial institutions have been battered and even at this point there is no certainty that the scale of the problem has been fully scoped. Secondly, the market for securitised assets is closed, removing a source of capital for banks and meaning that any new bank lending has to stay on the banks' balance sheets. At the same time regulators are raising the capital requirements for banks adding a further constraint on lending.

The consequence of this is going to be a severe credit squeeze for over-borrowed consumers and companies in the real economy. The early stages of this have been felt in late 2008 with borrowing and mortgage rates remaining high despite official rates declining, retail sales falling and some retailers going bankrupt already, and unemployment starting to edge up.

Our view is that the recession in the real economy is in its early stages and will get far worse in 2009 as the normal monetary policy levers will continue to have a limited impact and the focus shifts from banks' losses in the financial markets to their losses in the real economy.

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So in thinking about 2009 we start from a position where:

- Official interest rates in the major economies are low, will go lower (maybe to zero) and stay there for some time.
- Banks will be seeking to rebuild their profitability and balance sheets by keeping lending rates very high relative to official rates.
- There will be ongoing concerns regarding the quality of assets in the banks' balance sheets that will continue to spark crises of confidence in the markets. As the year progresses corporate bankruptcies will increase so this problem will not disappear.
- Liquidity will remain limited in many markets.
- In the real economy the recession will be deep - inflation will fall, unemployment will rise, corporate bankruptcies will rise.
- More frauds will come to light.

Interest Rates

There's been a lot of discussion about how much lower rates can go. That's easy, not much further. We need to look beyond that, and start to worry about what happens when rates start to rise again. The US, UK and Euroland governments are borrowing record amounts of money. To get investors to buy all those bonds we shall need much higher bond yields, at some point. We also have the risk that inflation will return when the recession is over. Our guess is that the peak of interest rates in four or five years time may be higher than last time. Certainly US \$ rates of 5% and £ rates of 6% are quite possible.

This is a tough background for investors in short bonds. If rates go up by 1% a year for four years then each year (on average) a portfolio with duration of 2 years will see its return reduced by 2% a year because of the rise in rates. In practice that probably means a near zero return for at least one of those four years.

Inevitably that suggests that durations should be reduced. Unfortunately that conflicts with the next recommendation.

Credit Spreads

It's being said that credit spreads are as wide now as they were in the great depression of the 1930s. That may be true, but it's probably not very helpful. In the 1930s most companies borrowed relatively little, certainly nothing like the leverage that is common today. As a result the depression bankrupted surprisingly few companies, because they could cut back on costs, reduce production and survive. The picture now is very different. Pressure to create "more efficient" capital structures has persuaded companies to borrow money (easy to do, after all) and repay capital to shareholders. A fine strategy when the economy is growing steadily, with few blips, but a potentially disastrous one when a deeper recession (let alone a proper depression) comes along.

That high level of gearing, particularly in the private equity space, is about to bankrupt a wide range of companies, almost irrespective of how good the underlying business is. This,

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in our view, is the main reason for credit spreads being at record levels. We're probably about to have record levels of business failure, and this time borrowers will recover much less from Chapter 11, or whatever other administration process is used. In the USA there is a general assumption across the whole market, that in bankruptcy bondholders as a group will recover about 40% of face value. This time it may be as little as 20%.

We've already seen the first bankruptcy in this cycle of a company still rated A-, when Lehman failed. It's probable that other investment grade bonds may suffer the same fate, partly because the rating agencies seem to be even further behind the real world than they were a year ago. The secret to survival for the next twelve months will be a manager who really understands credit risk, and knows how to do their research properly.

But let's not be too gloomy. With credit spreads at these levels most bonds are bargains. To be able to buy sound AA credits at 3% or 5% over US Treasuries doesn't happen very often. If you manage to dodge the failures these will look like amazing bargains in two years time.

There's one little problem in all of this, though, referred to at the end of the interest rate section. To get the most out of the eventual reduction in credit spreads you need to hold bonds which have some duration. There's not much benefit in holding a one year corporate, if you have to reinvest in a year's time at much lower spreads.

The ideal solution to this conundrum is to find bonds which have fairly long credit duration, but short interest rate duration. Fortunately they do exist, in the form of floating rate notes. The regular (every three or six months) reset of the interest rate on such bonds means that they aren't much affected by rising rates. But they may have five or ten years to maturity, so the credit duration can be quite long. The only problem is that FRNs are almost all issued by banks, and they aren't always easy to deal in. But we do feel they are worth considering as an instrument well suited to a period of rising interest rates and falling credit spreads.

There are other ways of taking advantage of high credit spreads without running much interest rate exposure. We'll be talking more about that during our annual investment conference on January 28th.

High Yield Bonds

For those that like to take a little more risk there is the high yield bond sector to consider. These are bonds which are rated BB+ or lower and are issued by companies which have less financial stability, often have higher leverage, and consequently have greater default risk than those issuing investment grade bonds. On the other hand they do have very high yields.

Currently this sector, as measured by Merrill Lynch's High Yield bond index, yields a stunning 22%. According to Moody's this yield implies that investors expect that one-fifth of these bonds will default. Although the default rate is currently 3% it is forecast to increase to around 11% in late 2009, a rate broadly in line with the peak default rate in the last two US slowdowns in 1990-91 and 2000-01. So this market does look attractive, unless defaults hit new peaks, and we do think there is a risk that may happen.

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Again, finding a manager that really understands credit risk is essential and could add alpha to the index returns if they can avoid owning some of the defaulting credits. Nevertheless even with the best managers a well diversified portfolio is essential. Investing in high yield bonds requires real skill and expertise. We're researching high yield bond funds at present, and will have a detailed report ready by the end of January. This report will provide a short list of high yield bond funds which we think are suitable for insurers who are prepared to take rather more credit risk.

Commercial Property

One of the great advantages of commercial property as an investment class is that it tends to lag behind what's actually happening in the world. This means that you can buy with rather greater safety because the evidence of recovery should already be there.

But first we expect to see UK commercial property prices fall quite a lot further. Already down 25% or so from the peaks of 2007, we won't be surprised to see another 25% fall. At that level we think that for insurers who can put up with some liquidity constraints this could be a very useful diversifier, with quite good inflation protection.

This again is an asset class which requires some expertise, but liquidity and cost are also important. We shall be researching the sector in more depth during 2009.

Equities

This is the really high-risk asset class, and we don't expect all our readers to feel comfortable with the idea. Nevertheless an allocation of 5 or 10% can provide a very substantial addition to returns when equities do recover.

Our favoured way of implementing this is through the use of tracker funds, which are very liquid and have low running costs.

Timing is very tricky, other than to say we think there's no rush. This is a subject we'll be covering in more detail at our January conference.

Hedge Funds

The hedge fund industry is going through a terrible time. Large redemptions have made many hedge funds liquidate their best positions not far off the bottom of the market, hardly anyone has generated the performance fees which they had come to rely on, and now Mr Madoff has cast a new shadow, of fraud, over the industry.

It's too soon to buy, we need a period of some stability, but our question for insurers is: How would you feel if half your competitors went out of business? Yes, you'd feel sorry for them, and glad to have survived, but you'd also be thinking about the effect that drop in competition would have on your P&L. Hedge funds are in a similar situation, with the biggest opportunities many have ever seen, and an industry probably halved in size by the middle of 2009. It's a fascinating position for the survivors to be in.

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Other asset classes

We've not covered commodities, or emerging market debt, or other exotic asset classes, because we don't think there's any need to look at them. The scope for profits in the investment grade bond market are large enough to excite the cautious investor, and for those prepared to take a little more risk equities and high yield bonds will be excellent value at some point in the next year.

To-do List

We'll be looking at all of this, and more, at our annual Investment Conference on the afternoon of 28 January. Invitations will be going out soon, and if you haven't had one by 8th January please phone or email colleen.briggs@mips.co.uk

There are now seven of us at Meridian working on investment consultancy, and it's a crucial part of our business. We are working for a wide range of clients, and we think we've helped all of them to avoid losses during the last 18 months. If we're not already advising you then please do talk to us about how we might be able to help. 2009 is going to be just as difficult as 2008, we expect.

DWO

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Earlier overviews can be found on our website:

http://www.mips.co.uk/doc/Crash1.pdf	August 2007
http://www.mips.co.uk/doc/Crash2.pdf	November 2007
http://www.mips.co.uk/doc/Crash3.pdf	January 2008
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