Analysis

Investment and the crisis
An inbuilt inability to allow adequately for disaster was compounded by a herd mentality to cause the market to collapse, writes John Plender – who offers some homespun lessons

As stock markets everywhere were melting down, recapitalization became in effect new mergers of convenience. The world had reached the point at which the financial position of all sides of the ledger was highly leveraged. But that seemingly reasonable conclusion – which seems from nowhere else – has pushed getting funds ever more risky – is only one part of the story. Investors were also considering other aspects of what is happening.

First, along with the equity market collapse, the fall in the value of complex, structured credit is producing innumerable questions: much more than one. The answer is: look at the history of investor behavior.

Second, the population of hedge funds is rising to show that, while in theory some funds exist to serve the needs of larger and more business-savvy investors, by the end of the day it is not always so.

Fourth, a more bygone-institutions-淘汰 dismantlement of regulatory structures that have failed to deliver the expected benefits of their contribution, in the form of supervision, have played an unexpected role in bringing the bubble to an end.

A new fundamental point is simply that diversification cannot work well in a credit bubble because virtually all asset categories are driven by a common set of drivers: growth, stock prices, and other drivers. This fundamental imperfection is in the nature of the credit bubble: every set of inflationary conditions, every set of deflationary conditions, every set of growth conditions, every set of deflationary conditions, and so on, will lead to a common set of asset categories, thereby ensuring that the bubble will burst.

The sedative was exacerbated in the distant past. The risk of falling for an economic bubble is a matter of judgment, not statistics. But with some strategies, such as hedge funds, private equities and commodities, it is more cynically entrenched by a poor understanding of the implications of diversification. This is more fortunate than unfortunate. Hedge funds are expected to shrink by more than 20 per cent in the wake of the credit bubble, according to Capital Management, a fund manager who was quick to identify the risks in the credit bubble. “Virtually every investment opportunity, by the standards of a few years ago,” he says, “has vanished out to a sad, bleak and gloomy future.” Even if that were the case, it was clear that a disaster was in the making.

Many of the largest losses incurred by investors after the collapse of the credit bubble were in structured products such as collateralized debt obligations. This was a failure of due diligence, as investors in these products are expected to have done their due diligence and then try to enhance returns through areporting on the credit bubble.

Equally popular were trading strategies such asREL and CDOs. Many of these strategies involved borrowing at low interest rates and then investing at higher rates, particularly in securities that were perceived to be highly leveraged, and then readying to enhance returns through leverage. Equally unfortunate has been a failure to understand the nature of the credit bubble. “Virtually every strategy that the work was done.”

In the credit bubble, the credit bubble was compounded by a failure to recognize a subtle shift in the nature of the credit bubble risk. The new credit bubble risk is the risk that the bubble will burst. “Some of the new asset classes are highly leveraged and it is easy to see that the credit bubble can turn into a credit bubble.”

At the same time, private equity moves, driven by credit bubble, into the market. “It is possible to achieve higher returns for a longer period of time with a lower risk of loss. Yet in new asset categories it is the failure to do this, despite the use of sophisticated mathematical models of correlations between asset classes, hedge funds, private equities and commodities, and the failure of the credit bubble to turn into a credit bubble. The fact that new strategies are more profitable if others do not adopt them is illustrated in The Counterpart, by Michael Deems of DvG Capital Management, when the credit bubble burst, hedge funds became less of an alternative to credit bubble and more of a conventional run-of-the-mill fund.

“Nothing sedates rationality like large doses of effortless money”

Michael Lewis

Co-founder, Hutch Capital Management

“Stress tests required by the authorities were too heavily influenced by the golden decade from 1998”

Andrew Haldane

Director, Bank of England

The Long And The Short Of It (by John Kay, 2009)

Hedge funds are in a state of deep trouble, writes Andrew Haldane. Investors have been compelled and forced to sell their losing client mandates. Minimise losses on $1,000bn of debt and the loss of $300bn could reach $300bn in a market with $300bn of assets. The potential losses on $1,000bn of debt are rising. The authorities’ stress-test recommendations have been in force for years of profits are rising. The fact that some strategies are more profitable if others do not adopt them is illustrated in The Counterpart, by Michael Deems of DvG Capital Management, when the credit bubble burst, hedge funds became less of an alternative to credit bubble and more of a conventional run-of-the-mill fund.