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Has the music stopped?

"In Breughel's Icarus, for instance: how everything turns away
Quite leisurely from the disaster; the ploughman may
Have heard a splash, the forsaken cry
But for him it was not an important failure.."
W H Auden

A fund manager recently noted that you know that things are bad when people start quoting Churchill (or Warren Buffet for that matter). For a number of years some of the more astute commentators have been expressing concerns about the credit excesses, the global imbalances and warning that we will rue the day when these unwind. Even these commentators have been surprised by the severity and the speed with which the financial crisis has unfolded.

The frenzied post-crisis analysis has been interesting to observe – the proximate causes being attributed to a narrow group, consisting of inter alia; regulators (complacency), the "spivs and speculators" (greed), to a wider group - savers and debtors in combination, as well as institutional investors seeking unrealistic returns and house price speculators.

In other words we were all part of the excess by either saving too much, such as the Asian saver saving too much but in US dollars to stop the appreciation of the domestic currency, which continued to support export based growth; or encouraging profligacy in others such as the easily tempted US consumer loading up with debt; or investors whose search for unrealistic return led to asset price bubbles based on leverage (institutional investors) and finally individuals who wanted to profit from the house price "boom".

Alternative explanations are "this was inevitable" given the prevailing economic model adopted (unbridled market fundamentalism), or a view that financial crises are an unavoidable part of the development of capitalism and to seek to avoid them is a pointless exercise (Rees Mogg via Ludwig Von Mises).

So what are investors to make of all this and how should they react?

In the short term, the crystal ball is cloudier then normal for a number of reasons. The severity of the developments and the impact on financial markets has been greater than expected by most market participants. The initial concerns which were focussed on liquidity have translated into concerns about solvency. The implication of this is that it is very difficult for market participants to establish price discovery (in other words to establish a "fair value" for assets) – the "normal" rules no longer apply and the pay-offs are asymmetric.

A number of value-style managers have fallen foul of the asymmetric payoffs and fallen into the "value trap" of investing opportunities which looked very attractive using the normal rules of investing, but which did not allow for the "reflexive" impact of other market participants. The difficulty of establishing price discovery is exacerbated by the fact that the policymakers' actions, not fundamentals are setting the marginal price in financial markets.

This will likely result in the continuation of market volatility - for financial participants the normal Monday morning "blues" are accentuated by policymakers who make pronouncements on Mondays after week-end deliberations.

The developments have thrown into sharp focus the difference between risk defined as the possibility of losing money and risk defined as volatility of returns (essentially a statistical artefact). A good example of this is cash, an asset class with close to zero volatility and having been seen as a risk-free asset is no longer free of risk. The immediate response of investors has therefore focused on actions which they can influence, resulting on closer attention in the area of operational risk, focusing specifically on the three "Cs"; cash management, collateral management and counterparty risk.

What about the longer term?

The fundamental changes to the banking model will have major implications. As Philip Auger has noted in the Financial Times recently, the crises, far from destroying investment banking, may well result in banking going back to its roots – which is for banks to be advisors and intermediaries, acting as agents not principals. This should result in investors not having to compete with banks for interesting investment opportunities.

The arguably knee-jerk reaction by regulators to short selling could be rationalised as follows – in essence that although hedge funds help correct mis-pricing in "normal" market conditions, they can subvert the system in times of crisis and actually cause mis-pricing via their reflexive actions.

The capital-starved banking sector is expected to result in slimmer prime brokers with a more limited capacity to finance hedge fund activity. So the pincer movement of regulatory change (short selling constraints, additional transparency requirements) and a less muscular prime brokerage industry will have a constraining effect on hedge funds.

The rationale for "turbo" skill based investing, which is essentially what a lot of hedge fund investing is about, remains but the growth of the industry is likely to slow (indeed the industry may shrink for the first time in many years) as a result of these developments. More intuitive strategies and more transparent strategies such as market neutral, long-short and global tactical asset allocation may well be favoured by investors until the dust settles.

Overall, market dislocations normally result in severe mis-pricing of assets and can provide opportunities for investors. Studies have shown that economies which have experienced crises are stronger as a result than economies which have not. One is reminded of Orson Wells (as Harry Lime) in the film The Third Man *"In Italy, for thirty years under the Borgias, they had warfare, terror, murder, bloodshed, but they produced Michelangelo, Leonardo da Vinci and the Renaissance. In Switzerland, they had brotherly love; they had 500 years of democracy and peace -- and what did that produce? The cuckoo clock."*

Per Mr Buffett, in financial markets being “greedy when others are fearful” requires courage but can be a very profitable strategy. Investors with a strong balance sheet and a long-term horizon and therefore the ability to take on illiquidity risk, such as sovereign/national funds and many pension funds, should be looking to increase their risk budgets albeit very cautiously. Investors with weaker balance sheets may need to re-think how their risk budgets are currently deployed.