

The 10 lessons of 2008

When something seems too good to be true

by TONY GIBSON

There can be few investors who are sad to see the end of 2008. It was a year that was as damaging to investors' egos as it was to their balance sheets. The damage inflicted on the ego was due to the fact that very few of us saw this one coming – especially the severity of the falls. Of those who did have the good sense to sell substantial parts of their equity portfolios ahead of the market collapse, only a small percentage were as a result of true foresight and wisdom. The remainder of those who were protected from the market falls were either lucky to have been liquid at the time (one should never confuse genius with luck) or are perennial bears anyway, and have been for such a long time that finally their ship has come in!

Rather than rehash yet another eloquent summary of the market woes during 2008, it would seem to make more sense to rather try to identify and examine some of the key lessons that investment markets taught us during the year. In no particular order of importance, we believe that the more identifiable ones are as follows:

1. If something seems too good to be true, it probably is

Surprisingly, we learnt this lesson as recently as 2000 when investors realised, in a very brutal way, that there are no 'new eras' and that excesses are never permanent. Despite the lessons of 2000, and following the massive liquidity injection aimed at avoiding a recession in the aftermath of the tech bubble burst, a new bubble began to form over the past few years. Taking the US economy as a proxy, this new bubble era was characterised by:

Structural and permanent dis-saving as consumers withdrew equity from their homes and spent it on consumer items. In addition, they furiously spent borrowed money on credit cards 'knowing' that their balance sheets were bolstered by rising equity and housing values.

Real estate values were consistently appreciating at a pace in excess of the nation's income growth.

The growth in the nation's productivity seemed to increase at an unstoppable trajectory – even Alan Greenspan believed this to be a permanent phenomenon.

Companies' profit growth was consistently above economic growth and therefore continued margin expansion was deemed to be normal.

We now know that these characteristics were indeed too good to be true. The US economy has now moved into a recession, predicted by some to be the worst recession since the 1930s. Capital expenditure by companies is in steep decline, consumer spending is down sharply and the savings rate is rising dramatically.

2. Leverage amplifies... and then kills

Leverage is a very addictive drug – and the Anglo-Saxon world got high on it. It became pervasive at all levels of the financial system. The best documented example is of course the excessive borrowings of a whole new generation of unqualified home owners and credit card consumers. However, at the same time, the use of credit by the financial sector (such as investment banks and hedge funds) reached unprecedented levels. Borrowings by hedge funds and financial

institutions such as Lehman Brothers reached levels way in excess of what the investment community believed it to be. In fact, this borrowing binge took the level of private sector borrowings in the US, as a percentage of GDP, to a massive 275%. To give this number some perspective, in 1929 this ratio peaked at 225%, and as recently as the 1980s the ratio was as low as 125%. Alan Greenspan presided over an era of extreme credit creation. This leverage dramatically amplified asset prices, and in turn led to consumer spending assuming a force which became accepted as being a non-cyclical phenomenon. This virtuous circle in turn led to company profit margins reaching record levels, and being sustained for a record period of time.

This party has of course come to an abrupt and unpleasant end, with the resultant and well documented freezing-up of global credit markets. A number of iconic names, particularly in the investment banking arena, have been killed off by the reversal of the financial largesse.

3. Smart money crowds out smart money

Another by-product of the massive build up in leverage was the amount of capital that flowed into investment products that seemed to offer higher returns for lower risk. Much of this capital was allocated to hedge funds, private equity funds and the trading desks of investment banks. As the available capital grew, money managers increasingly found themselves competing in the same investment pools – but with a shrinking opportunity set. They therefore became eager and willing participants in the new innovative products created by the ever creative product designers at the investment banks. Credit default swaps and collateralised debt obligations are two well documented examples of these products.

When the credit bubble burst and the desperate rush for liquidity began, money managers were appalled to discover the extent of the crossover of assets which they owned. Whether it was owning the same illiquid and over-hyped equities, or trying to find the new marginal buyer for corporate debt, there was nowhere to hide. These commonly held investments became known as 'hedge fund hotel' investments. The point being that too much capital allocated to smart and innovative investment products provides the very quicksand that consumes capital via asset markdowns. Put another way, too much capital in the hands of sophisticated investors has led to near disaster for all.

4. Markets are increasingly prone to bubbles

It will not have escaped the attention of market observers that investment bubbles seem to be occurring more frequently. In the space of ten years we have experienced two of epic proportion. The tech bubble of the late 1990s and the current credit bubble were both attributable to the belief by investors that the old investment rules no longer apply. The tech bubble was based on the excitement surrounding the invention of something so big – the internet – that 'this time it was different'. Exhibiting the same naivety, investors' acceptance and enthusiasm during the credit bubble build-up was predicated on the belief that recessions were effectively a relic of the past due to the securitisation of risk.

It will be the subject of much debate as to what is the cause of the more regular occurrence of investment bubbles. It is quite possibly related to the use of technology and the mentality of today's capital allocators – many of whom are long on bold theory, but short on intrinsic investment experience. This has inevitably added hugely to the increasingly momentum driven nature of investment markets.

5. Markets tend to return to the mean over time

This has been a difficult lesson of 2008 as investors effectively missed where the true diversion from mean actually existed. As we moved into the year we knew that the housing market in the US was slowing dramatically, and that a sharp economic slowdown was in prospect. However, any bearish sentiment was tempered by the belief that equity markets were fairly valued rather than over valued; as was the case in 2000.

Unfortunately, the point that was generally missed was that the use of excessive leverage in large parts of the world was the unsustainable deviation from the mean. The economic successes which had propelled company profits to record levels was

in fact largely fuelled and sustained by massive credit accumulation. As the truth has unfolded, with the realisation that it will take years for mean reversion in the use of credit to play out, equity markets have been severely punished due to their having been used as the primary source of liquidity creation.

6. Exponentially rising or falling markets usually go further than you think – but do not correct by moving sideways

This lesson applies to the investment markets as a whole, but in a more amplified way to commodity markets. Where a large degree of overvaluation is apparent to many investors, it remains human nature to assume that 'a period of sideways movement in prices' will allow valuations to move into the definition of fair value as profits continue to grow. This has proven to be a dangerously one dimensional view on life in financial markets. Firstly, history shows us that corrections do not occur in this way, but more importantly, the implicit assumption of continued growth in corporate profits is the first precept to be abandoned once the economic environment takes a turn for the worse. In most cases, it is this loss of confidence in the sustainability of profit growth that causes the market to react violently.

7. Normal investment rules ceased to apply when an event such as Lehman's collapse occurs

Firstly, the collapse of Lehman Brothers was not expected by financial markets. Secondly, at the time of the collapse it was not fully appreciated just how unsettling a message this would send to financial markets. However, at that point of realisation, normal investment rules went out of the window as the market was forced to adjust to the freezing of liquidity across the capital and financing spectrum. The main consequence, and hence lesson from this, was that suddenly investors did not have the normal luxury of taking investment decisions based on a long-term investment horizon. When markets begin to demand liquidity at almost any cost, a new set of (generally irrational) rules kick in. This creates a very difficult and unrewarding time for long-term, value focused, investment managers in which to operate.

8. Do not underestimate the extent to which valuations can compress during a bear market

The main environmental factor about the market collapse, which caused many active managers problems, was that value stocks with the strongest earnings prospects seriously underperformed, while investors crowded into the same group of high return on equity companies. This was presumably based on the logic of looking for the most defensive shares within each sector. Generally, the managers selected by Coronation apply fundamental research aimed at seeking out cheap shares with better than average earnings growth prospects over the longer term. Analysis of the period from May 2008 onwards – when the market decline accelerated – shows that stocks with low price to sales ratios, and low price to book ratios and stronger expected forward earnings growth, actually led the market down. Cheap shares therefore performed especially badly, while investors crowded into the same defensive shares across all sectors. Put another way, shares fell more readily from a P:E ratio of 8 to 6 than they did from a P:E ratio of 14 to 11 – the same percentage move.

9. Sometimes going into cash is the only hedge

Investors had adopted the mindset that to be fully invested in equities over the past 25 years was, by and large, the correct strategy. That said, in an abnormal investment environment, as has been the case in 2008, fully invested strategies have battled to properly hedge away risk. Reducing market exposures and raising cash has been one of the few effective ways of protecting capital. While this comment applies more to hedge funds, managers of old fashioned balanced funds will also have been reminded that, during periods of market stress, cash does play a vital role in managing investment portfolios. The strategic and prudent use of cash in portfolio management is not a relic of the past.

10. Bull markets are more fun than bear markets

Let's look forward to 2009!

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