First State Investments

EXPECTING THE UNEXPECTED: THE GLOBAL FINANCIAL CRISIS PART 1 – LIQUIDITY, PLEASE

- A systemic crisis begins, borne out of the US housing market
- All risk assets are affected during this time: July '07 to July '08
- Lesson learned: Liquidity can become extremely tight, affecting asset prices

As far as financial disasters go, The Global Financial Crisis (GFC) of 2007 / 2008 has reserved its place in history as the one that nearly broke the financial system, working its way deep into the real economy, creating global mass unemployment and affecting the lives of millions of people. For investors, regulators, governments, ratings agencies, bankers and central bankers, it was an important lesson in the complexities of risk and the knock-on effect of its mismanagement, as well as the fragilities created by bingeing on debt.

For Andrew Harman, of the First State Diversified Growth Fund, the events of the GFC have also provided the opportunity to examine the impact of such severe asset price shocks across his portfolio today, enabling him to better prepare it for any twists and turns future markets may bring. This approach, he believes, makes the fund particularly attractive for those looking for capital preservation as well as capital growth.

It was 2006 when toxic assets started to burn a hole in the balance sheets of banks around the globe, but in the preceding years the 'Great Moderation' – years of low interest rates and stable growth – had set the scene, encouraging debt to balloon and risk-taking to thrive. Why so much cheap money swilled around is open to debate: some point to vast savings in Asia; others, central bankers anchoring rates too low. Whatever the reason, it encouraged investors to seek out better risk adjusted returns and spurred massive demand for questionable financial assets. European banks, booming since the creation of the euro, were amongst some of the biggest buyers.

One asset proved particularly popular: the collateralised debt obligation (CDO). These were attractive because of the manner they sliced-up risk, creating tranches of varying quality to meet the appetites of different financial institutions. The problem was they only work if the loans packaged inside them are uncorrelated; mortgages from different cities within the US housing market, which filled many of the CDOs, were not. But all of this was not to be unearthed while the housing market was rising.

Mortgage lenders then started doling out subprime mortgages to keep the CDO engine generating fat profits, but banks had lost sight of their risk. The housing market turned. As defaults spilled over into the supposedly safer tranches, the CDOs that banks had loaded themselves up with became worthless, and they were forced to record enormous mark-to-market losses on their balance sheets . With regulators having failed to ensure proper capital buffers, liquidity - and trust - evaporated overnight.

It was the summer of 2007 when the crisis reached its 'active' phase. The sheer size of the systemic issue started to become apparent to investors ranging from big financial institutions to insurers to pension funds to hedge funds. As a widespread credit crunch set in, so did fears of a global recession and even depression and markets reacted with extreme risk-off repositioning, blowing out credit spreads and dropping equity markets worldwide.

A key feature of markets during this year was the impossible trading of less liquid assets: trust had evaporated alongside liquidity, probably best demonstrated in the widening of the LIBOR spread. Rebalancing portfolios or reducing positions was extremely painful with assets being sold at a fraction of their former worth.

Rapturously evident during this time was that safe havens were only to be found in the most liquid of assets, particularly in the more defensive currencies such as the Swiss Franc, Japanese Yen and US Dollar; as well sovereign bonds such as US Treasuries or UK Gilts. All of these strengthened in value during this time.

For these reasons having an allocation to cash-like short-term government bonds in the portfolio provides the opportunity to dynamically capture market opportunities. US Dollar exposure has also been increased more recently as a highly liquid currency, looking attractive as stronger fundamentals feed through with a combination of a better macroeconomic outlook and higher interest rates relative to other markets. These liquid positions serve to protect against extreme market falls in the event of a crisis.

The next article will explore the next phase of the crisis and further lessons learnt. For a more detailed and transparent look at the portfolio's current asset allocation, including rationale through its history, please visit our DGF Navigator.

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