

Russian roulette

Imagine you are offered \$5 million to play Russian roulette. If you put a revolver with a bullet in one of the six available chambers to your head, there are six possible outcomes – five of which are highly favourable and one of which is fatal. While there are six possibilities, in practice, only one event occurs. Would you congratulate a Russian roulette winner? Probably not as you recognise the potential for an alternative outcome that is not worth risking. You see the folly in this behaviour because you recognise what could have happened. Imagine instead that it is difficult to understand what the other possible outcomes are; might the winner become a role model for others who also start to play? And might the winner keep playing with the inevitable consequences? Do you have the patience and insight to bet against a roulette gambler? For many investors the answer is no.

How good are you at understanding what might have happened? There always exists a whole range of ‘alternative histories’¹ – things that didn’t happen but might have. If Russian roulette sounds deadly, investment markets are more insidious because they lull investors into a false sense of security making it hard to believe that the bullet exists at all. And then just when our confidence is at its highest, our money is stuffed into the riskiest assets and it hits us.

Much of modern portfolio theory assumes that investors are knowledgeable and rational, and consistently make sensible investment decisions. This often isn’t the way it works in practice. Investors seem to often make decisions that are not in their own best interests by responding to emotion, not logic. But that’s not the whole problem. The investment world is confusing and complex; we are all swamped with information. As a result (understandably) many of us use rules of thumb or short cuts that help us make sense of things. Extrapolating the past is one common shortcut. For example, assuming it won’t rain today because it didn’t rain yesterday is a good way of getting wet. Assuming the market will go up because it went up yesterday is a good way to lose money. Shortcuts can be useful but are often misleading because we focus on the wrong things.

For example the return track records of funds seem so compelling despite copious warnings about the perils of past performance. There are two major problems in relying on past performance to select an investment. The first problem is that focus on past performance changes investment strategies. The second problem is that you can only see the track record for one particular history – the one that happened. You have no idea whether relatively high returns are due to skill or luck; or whether low returns are due to lack of skill or appropriate risk management. A manager might argue that taking high risk in what turned out to be a high returning environment is based on its skill and insight. But I’d apply a big dose of scepticism to those that made such claims in the lead up to the credit crisis. Conversely, strategies that lagged in the period of stellar returns from Australian property and shares are now proving their worth by outperforming as the true risks are revealed. Among those previous laggards are strategies that rightly took into account the possibility that things could go wrong. In other words, they considered a range of possible histories and understood how to manage risk.

It has been clear to us for some time that the apparently highly-positive global environment was seriously flawed. In terms of economics the environment has some similarities with the period leading up to the Bretton Woods crisis of the early 70s. The run up to this period also involved overspending in the US (in that case by the Government) and impediments to the free operation of markets (wage and price controls plus currency rigidities) which ultimately proved to be unsustainable. A realignment of the currency regime of similar magnitude is likely ahead.

From a financial markets perspective there are similarities with the savings and loans (S&L) crisis of the late 1980s and early 1990s. In both cases a property boom encouraged imprudent lending. These risks were concentrated in lending institutions during the S&L crisis, while securitisation and financial engineering resulted in risks being far more dispersed currently. This greater dispersion generally tends to be seen as a positive – fewer financial institutions may fail or need to be bailed out. However this dispersion and the complexity of vehicles that hold the risk reduces transparency and makes it difficult to assess the scale of the problem. The ultimate cost of the S&L crisis has been estimated at \$160bn (\$124bn of

¹ This is Nassim Taleb’s term. His book ‘Fooled by Randomness’ offers that rare combination of an entertaining read and great insight into market and investor behaviour.



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this was paid by the US Government). In today's dollars this is equivalent to around \$250bn. Bridgewater estimates that today there is a total of \$700bn (once marked to market) in credit losses that are known, with banks having the biggest problems. Bridgewater also points to the more than \$500 trillion in outstanding derivatives – this is eight times higher than ten years ago. The dramatic credit expansion must inevitably be followed by a credit contraction. It is very difficult to see that this will not mean slower economic growth or recession, and lower returns from equity markets.

How painful this process of adjustment turns out to be depends on the behaviour of both investors and policy makers. The role of policy makers is to foster economic stability. There have been rapid responses from the Federal Reserve in particular. Their dramatic 75bp inter-meeting cut in January is consistent with previous aggressive action to support markets in times of distress. While markets applaud such moves, over-accommodation by the Fed is at the heart of our current problems. Over-willingness to bail out takers of inappropriate risks encourages them to take more risk. The moral hazard it creates is extremely dangerous and can seriously undermine economic stability. Attempts by policy makers to boost growth in the US through fiscal and monetary policy may backfire by increasing rather than eliminating the underlying excesses.

It is not possible at this point to determine how far markets are through the adjustment process. Our assessment is that although the investment environment includes clear long-term structural positives, it also remains one of relatively high potential risk. There is obvious risk (though by no means certainty) of an escalation in the crisis. The recent pattern of market reversals is not unusual. We do not believe that there can be certainty as to whether a full scale selling panic will eventually occur or not, or whether the financial distress will gradually subside giving way to the emergence of a more positive environment. Predictability is particularly low because of the importance of sentiment in determining outcomes. The greatest threats lie in both an escalation of investor risk aversion and policy mistakes during a complex and volatile environment.

Investors may be rightly asking why investment managers have not done more to protect the value of their portfolios in such a negative investment environment. A major impediment to effective risk management is investors' focus on past returns. Considerable business risk results when managers lag peers in performance surveys. By chasing the strongest performers, investors force managers to limit the extent to which they stray from peer funds. In doing so, investors are effectively defining the range of asset allocations that are acceptable. This seriously limits the ability of managers to focus on absolute return objectives.

Looking forward what are the lessons? Remember that the future is uncertain and risk always matters. In selecting an investment strategy be very wary of picking the strongest performers in boom times. Understand that performance survey rankings often tell you little about which strategy to choose – although the changes in survey rankings that occur as we switch from a boom environment back to reality can be very revealing!

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