The investment adviser: George W. Hosfield

by George W. Hosfield, Guest opinion

Friday September 19, 2008, 7:03 PM

How bad is this situation? Compared to other economic crises, is this one any worse?
Confidence in financial institutions, especially in light of recent events (Bear Stearns, Fannie Mae, Freddie Mac, Lehman and AIG) is perhaps at its lowest ebb since the Great Depression.

In terms of scale, bank losses to date total $500 billion and counting. If this were to ultimately double to $1 trillion, it would equate to 8 percent of GDP (Gross Domestic Product), which is approximately equivalent to the $300 billion in losses associated with the S&L crisis (1986-1995).

Perhaps what sets the current, rolling financial crisis apart most from other contagions is the interconnection between disparate entities (banks, insurers, investment banks, hedge funds, etc.) on a global basis. Further compounding the anxiety is the complexity of the opaque and often illiquid instruments that link the financial entities. However, the elevated level of anxiety may be overdone, especially given the swift and creative responses of the federal government.

Who's likely to feel the pain?
In addition to the obvious capital loss associated with the broad decline in stock prices, the "pain" is being broadly felt in the sense that access to credit has become more scarce and costly. Clearly, more jobs will be lost. Connecting the dots is fairly easy: Construction, anything related to real estate, finance, autos, all will all continue to shrink. As with previous financial crises, there will be clear winners and losers. Generally speaking, the biggest losers in periods of "de-leveraging" are those entities that are debt-laden and forced to sell assets. The winners, of course, will be those that are deep-pocketed and who can acquire these assets at bargain prices. Ultimately, many will profit from this debacle.

What counsel do you have for investors?
Take a deep breath and don't do anything drastic. Think of the Hippocratic Oath: first, do no harm. For investors who have the proper asset allocation and a diversified portfolio, now is not the time to abandon risky assets such as stocks. History has proven the folly of selling when blood is in the streets. In short, stay the course and wait for calmer times to prevail before reassessing your risk tolerance and revising your asset allocation.

Do we need more or less government intervention as we go forward?
Presently the federal government is the only real source of support for distressed financial entities. While difficult to predict which, if any, institution may require intervention, it's certainly possible the feds will be called on to forestall another systemic meltdown. Longer term we expect an increased regulation and oversight of the financial markets, especially with respect to mortgage lending and insurance practices.

If we've learned nothing more over the last few weeks, markets can be very emotional and inefficient in the short run. This especially so when illiquid, opaque assets are involved. Possible regulatory changes would entail a modification in mark-to-market practices, increased transparency with illiquid assets, and creation of standards for derivatives and restoration of the uptick rule.

But the biggest change at the margin will involve a dramatic re-calibration of risk in the system. We are going through that right now and that's good news. The bad news is that at the end of the day, there will be less credit in the system, and it will be more expensive. It is a prescription for slow economic growth and we have rigged our sails for that kind of weather.