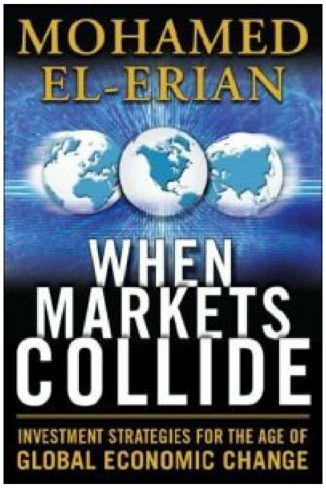

Book When Markets Collide

Investment Strategies for the Age of Global Economic Change

Mohamed El-Erian
McGraw-Hill, 2008

Recommendation

Mohamed El-Erian is a major name in global money management, and his insights once guided the Pacific Investment Management Company (PIMCO) – one of the world's largest investment managers – into profitable territory. Given his background at the International Monetary Fund and at Harvard Management Company, you won't be surprised that his global perspective and practical applications of behavioral psychology are well informed, interesting and helpful – to the right audience. His advice applies mainly to institutional investors seeking a new global vision that will identify the forces affecting today's markets. El-Erian's stories about high-level macroeconomic policies will appeal to those big investors and economic decision makers, as well as to individual investors who are searching for new ideas. Though some parts of this analysis have become slightly dated, the overall message remains smart and valid. While never offering investment advice, *BooksInShort* recommends El-Erian's valuable text to policy makers and investment professionals.

Take-Aways

- Major changes in markets initially take the form of "noise" – that is, odd occurrences that shake traditional relationships or ways of doing business.
- Traders can recognize noise if they're street smart and understand financial analytics and economics.
- The growth of emerging markets and novel financial instruments signaled shifts in global market conditions.
- The US markets' meltdown, starting in July 2007, surprised regulators and participants.
- The 2007 credit crisis set the stage for global financial change.
- To succeed today, investors must monitor events in developing markets.
- In the future, emerging economies will have to manage larger capital inflows.
- Investors should make asset allocation decisions using a three-year time frame, but should review their choices annually.
- Given global economic changes, enhanced risk management will become critical.
- If policy makers and investors act together, they can deliver improved performance, greater global growth and a more stable investment environment.

Summary

Dealing with Transformations

Investors today have to cope with a constantly changing environment. Economic transformations are unpredictable and difficult to identify because they develop quickly, but investors can suffer financial losses if they fail to recognize when shifts are coming and what they portend.

> "The financial market turmoil that started in the summer of 2007 reflects the secular transformation of the global economy."

Fundamental alterations in the global economy precipitated the 2007 US mortgage market collapse. This far-reaching event involved a complex convergence of novel financial instruments, types of investors and investment entities, as well as shifting demographics. These conditions still prevail, and their myriad repercussions remain hard to spot. However, investors who understand these shifts can hedge against the risks of rapid change and can earn profits.

> "It is important to realize that the forces behind the recent financial crises have not gone away."

Market participants may first detect "noise" – that is, unusual irregularities that shake traditional, long-term connections or ways of doing business. Observers often make the common error of perceiving noise as temporary and, therefore, they mistakenly ignore it, even though noise can indicate impending, fundamental change.

> "What started as a problem peculiar to the subprime segment of the US mortgage market has morphed into a series of collapses whose impacts are being felt on both Wall Street and Main Street."

Traders with instinctive street smarts, a formal grounding in economics and a good understanding of finance analytics are better equipped to recognize when noise is more serious and to determine if it is leading to a major shift.

Starting in 2004, noise went from signaling successive linear discrepancies to indicating simultaneous alterations in worldwide market conditions. Three factors underlined the swings in global marketplace noise:

1. **"Fundamental realignment of global economic power and influence"** – Emerging markets grew to displace some Western economies in size and clout.
2. **"Pronounced accumulation of financial wealth"** – Former debtor nations became creditors, as developing countries established sovereign wealth funds (SWFs) that could make significant investments globally.
3. **"Proliferation of new financial instruments"** – Innovations such as derivatives can hedge risk, but they can also be "weapons of financial mass destruction."

> "By challenging conventional wisdom and historic entitlements, transformations feed a dynamic that is inevitably uneven and, at times, unpredictable."

Combined, these new forces have altered the global investing landscape in such areas as price creation, economic growth and capital flows. In addition, the markets' growing interdependence has diminished the benefits of diversification. Investors who understand these realities will perceive potential gains and pitfalls more accurately.

> "Ongoing transformations alter in previously unthinkable ways the configurations of risk and return."

Other indicators of shifting markets include problems with valuations and pricing, as well as the emergence of structured investment vehicles (SIVs) and other mechanisms that aren't part of most corporate balance sheets. When these products failed in the run-up to the financial crisis, they crippled the American banking system, as well as money market funds and the commercial paper market, and pushed entire countries into crisis.

Entering New Territory

Events that once seemed like aberrations in the financial markets have become commonplace. As early as 2005, economic experts such as Alan Greenspan and Larry Summers said they couldn't explain how the yield curve was behaving or why global payment imbalances had developed, with capital flowing from poor countries to rich ones. An increase in the number of risky, leveraged products and of investors willing to buy them accompanied these shifts.

> "The present turmoil is neither the beginning nor the end of the transformation phase."

One major variation was developing nations' growing surpluses. These countries became stronger and they soon turned into US creditors. This historic switch affected foreign exchange rates, company valuations and bond prices. Today, developing nations are providing a stabilizing force in the global economy, as well as new sources of capital. In the financial crisis, the SWFs of developing markets, such as Abu Dhabi, Singapore and China, helped recapitalize huge banks such as Citigroup, UBS and Morgan Stanley.

> "What began as noise for many investors and policy makers became a signal of a major redefining of the global financial system."

While these changes were occurring, the US stock and bond markets began behaving unusually. In 2005, the US federal funds rate climbed 150 basis points. In normal times, this would have produced an increase in long-term rates, but instead long-term rates fell as short-term rates rose, which generated an inverted yield curve. In this scenario, bond investors with a longer time horizon were penalized, not rewarded, for buying longer-dated bonds. This inversion happened at the same time the US stock market was rising, typically a signal of strong economic growth.

Missing the Boat

Many investors and experts turned to the International Monetary Fund (IMF) as the logical institution to act as a main adjudicator. But for a variety of reasons, the IMF has failed to fulfill this role. The IMF may have lacked the expertise to foresee the impact of new products on banks and their balance sheets.

> "Indeed, in many ways the subprime debacle (and relate turmoil) constituted the first (but not the last) modern episode of a global securitization crisis."

In 2007, HSBC took back onto its balance sheet about $45 billion in holdings from two SIVs. This had the effect of cutting its regulatory capital ratio. Soon, Citigroup followed suit, prompting the credit rating agencies to downgrade the banks. Citigroup suffered due to its degraded credit rating, and it had to seek outside capital. By January 2008, an early report found that Merrill Lynch, UBS and Morgan Stanley had joined HSBC, Citigroup and many other financial institutions in tallying up $108 billion in portfolio and securities write-downs.

> "Markets collide as new actors, instruments, products and institutions assume greater systemic importance and do so in a manner that is different from that exercised by the previous sets."

The beginning of the meltdown in US capital markets in July 2007 was a huge surprise to regulators and the markets. Most large investors expected any significant problems to begin in an emerging market nation, not in the United States. But as the crisis unfolded, developing markets fared better than America did, since some purchased debt from developed nations at bargain prices. The 2007 credit crisis set the stage for global financial change.

> "In many instances the correct and wise reading of history suggests that it is best to dismiss the notion that 'things will be different this time around'."

However, in the course of day-to-day life, most people don't recognize fundamental shifts, so they remain confused by irrelevant data and distractions in the marketplace. A variety of factors shape investor behavior, including asymmetrical information, information failures, emotional and rational biases, failure to interpret complex signals, and greed. Some investors repeatedly make the same mistakes for reasons rooted in behavioral finance and neuroscience.

Looking Ahead

To succeed in the future, investors must predict events in developing markets as well as developed ones. They also must gauge the impact of new capital flows and new products on market fundamentals, since emerging markets have become major contributors to global economic growth.

> "Just a few years ago, developing countries were viewed as the predominant sources of economic disruptions, and for good reasons."

Investors must analyze whether such markets as China, Russia, Brazil, India, South Africa and Mexico can sustain their positive momentum. As emerging nations continue to see surpluses in their internal reserves and current accounts, they could launch policies to stimulate their internal consumer demand, and that could affect trade patterns.

> "Think of the asset allocation question in the following way: How would you best allocate your capital among different asset classes if you knew you were going to be forced to go away for three years and would thus be unable to change the allocations?"

When a country moves from being a debtor to being a creditor, it travels through four phases: First, it doesn't initially realize the impact of its growing capital reserves, assuming the surplus is temporary. Second, when it does recognize its external account growth, it often issues domestic debt, invests in US Treasuries or outsources the management of its reserves to the Bank for International Settlements, the central bank for central banks. Third, the country starts to buy back its foreign debt and manage its liabilities. At this point, it may form a SWF. Fourth, the nation improves its infrastructure, makes the transition to a consumer-led economy and updates its currency policies.

> "Investors tend to underestimate extreme events."

Managing larger capital inflows, which affect currency values and inflation levels, will be a big challenge for developing economies. However, they can fashion appropriate fiscal, monetary and exchange rate policies to direct the situation effectively. Increases in national wealth will also fuel the growth of SWFs, which some observers have vilified for their supposed intrusions into political, military and commercial ventures. The SWFs' full disclosures of their governance and other operational structures should reduce these concerns.

Amid these changes, investors could face problems related to mistakes in policy implementation and market breaks. The US Federal Reserve has to cope with rate fluctuations that affect liquidity and with the emergence of inflationary and deflationary forces. The impact of these monetary events depends on a number of domestic and international variables, including shifts in labor and wages in emerging market countries.

Benefiting from Change

To benefit from these global investment fluctuations, investors must focus on proper asset allocation and the right financial vehicles. Investors should make asset allocation decisions using a three-year time frame, but should review their choices annually. Those who seek balanced growth may want a globally diversified – as opposed to US-only – equity portfolio. This equity allocation should be from 30% to 54%, with a maximum exposure to US equities of one-third to one-half of that allocation. For an average long-term investor, the bond allocation should be in the range of 10% to 18%.

In this environment, portfolios should include real assets – such as commodities and real estate – that protect against inflation. Alternative investments, such as hedge funds and private equity funds, have a role but require careful manager selection and often have long holding periods.

A Plan for Policy Makers

These ongoing global economic transformations will demand multilateral policy modifications among all participants. Investors must understand these changes since they will affect the quality of investment information and the accuracy of economic indicators.

To remain the top destination for global inflows, the United States will have to address its current account deficit and exchange rate differentials. To remain attractive to investors, America must cut household debt, and its lenders should enact stricter loan requirements. Looking ahead, the US should improve its debt liability management by maintaining a predictable issuance schedule, promoting liquidity for individual issues and issuing debt along the entire yield curve. Taken together, these steps will enhance credit risk management and pricing, while making markets more liquid.

Managing Risk

Given these global economic variations, enhanced risk management practices are critical. Most individual investors leave risk management to the professionals. Money managers have many more risk strategies at their disposal, including the use of various hedges and so-called "tail insurance," which attempts to provide "Armageddon protection" against the most extreme market outcomes.

Better risk management also means more diversified portfolios that include various geographies and asset classes. Volatility will increase as investors redirect capital from the US economy to emerging market nations. Global disinflation, as a result of more workers entering a cost-effective global labor force, will accompany this transition.

This worldwide transformation also will help rectify income inequality and poverty, as many more emerging economies develop and use their excess savings to promote growth. To be effective, this shift will require the cooperation of both the private and public sectors in the form of new policies and regulations. If policy makers and investors act together, they can deliver improved performance, greater global growth as well as a more stable investment environment.

About the Author

Mohamed El-Erian, former CEO and co-CIO of PIMCO, is chief economic adviser at Allianz.