

Investment Credit Crunch

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Most economic cycles end with banks having lent too much money to the wrong people.

The credit crunch has its origins in sub-prime US mortgages. It now seems obvious to everybody that if there is no risk in lending an inappropriate amount to an inappropriate person, because you are able to package up and sell on that 'risk', then this simply encourages more lending to more inappropriate people. The problems have been intensified with multiple levels of leverage; the old adage "never leverage an illiquid asset" having been seemingly forgotten.

Sadly the end buyers of that risk either didn't understand what they had, were lulled into false security by the incompetence of ratings agencies, or were simply greedy for extra return whatever the risk; and so an investment tragedy unfolded for otherwise unconnected entities ranging from Scandinavian municipalities to small pension schemes.

The first signs that all was not well were actually evident a couple of years ago. US house prices did nothing dramatic, other than that in some areas they simply stopped going up, which was all it was going to take to fold this house of cards. This in itself removed the pillars of sub-prime and speculators' confidence as their whole thesis was predicated on prices always rising. An astonishing number of new build properties remained empty as those who had laid down deposits saw that discretion was the better part of valour, and walked away from the deal and the deposit. Supply and demand, the ultimate arbiter of investment value, reversed 180 degrees, especially as mortgages were getting reset at higher levels.

This was the start of the credit crunch, which itself is in many ways now simply a measure of confidence. Banks no longer trust in lending to each other, and many people looking for a mortgage have found out that banks no longer trust them. But these people can mistrust banks back, however, by selling their shares.

Economies suffer when credit dries up, as companies and individuals cannot finance spending, or at least not so easily, and their debts become harder to service. Money has been too easy to come by in the past, but this is changing rapidly.

Asset prices have fallen dramatically, unemployment is starting to rise, and we haven't even moved into recession yet. Worst of all, it is not just consumers who have over indulged on money they are yet to earn, and fingers crossed they keep a job so that they *do* earn it.

The UK Government has managed to do the debt thing too, by squandering a promising fiscal position. Its finances are the equivalent of a very poor endowment policy, whereby the investments have been embarrassing (selling gold at the bottom of the market), the profits squandered (public services) and hence an increase in premiums is required (stealth, and not so stealth, taxes).

Investors don't like what they see on the investment horizon and have been increasingly taking the view that cash is king. Banks and building societies are desperate to increase their levels of deposits and are offering attractive rates. Depressingly for investors, bonds, equities and commercial property have taken a performance holiday, similarly hit by the bad news of unexpected increases in inflation, and tighter than ideal monetary policy.

However, market gyrations are nothing new and the ability to ride out such events is a key trait that ensures investors get rewarded and why there is an equity risk premium. If markets went up in a straight line then that premium would be much smaller! A sizeable chunk of the investing population captures materially sub-market returns simply because they *do* get squeezed out of difficult markets, only to re-enter the fray when the coast is clear i.e. conditions have improved and the market is substantially higher. No one is going to sell investors their assets at a discounted price when good news abounds. Equally, no one is going to take those assets off our hands, in a falling market, at prices that do anything other than suit them. That is why there is the old investment maxim that, if nothing else, "lean into the wind".

The chance of timing your way in and out of market tops and bottoms is minimal at best, and you will need to be long on focus, wisdom, and probably luck to succeed. If you do get it right once, you are still just as likely to get it wrong the following time, and hence end up losing the same percentage but of what is now a greater amount.

So, what can one do then? Well, as ever with sensible investing, the answer is "asset allocation". Even with the reduction in value in most asset classes over the last year, a diversified multi asset class approach is likely to have protected a portfolio's downside much better than a traditional equity-dominated or equity and bond strategy. That is not to say that such a portfolio won't have gone down in value, it is not 'absolute return', although bear in mind that only cash is.

By consistently and systematically rebalancing back to target asset allocation weights, one can maintain the appropriate risk exposure on the portfolio, but also take profits in the better performing asset classes and average down the relative purchase price of those that have lagged. At once you are behaving as a contrarian investor, and also preparing yourself for any mean reversion in asset class performance – mean reversion being one financial characteristic that you *can* rely on. So, we have a diversified portfolio, with below average volatility, which can gain traction in the markets without any need for particular insight on anyone's behalf.

Such an approach should weather most storms, and rebound more efficiently from bear markets, inevitable as they are. So, the best advice for such an investor right now would be to sit tight and try to avoid the indignity of getting frightened out of a sensible investment approach only to buy back in at higher levels.

For those who can commit new monies: equities, bonds and property are all much cheaper than 12 months ago, and one may well be able to average down on the book cost of a portfolio. However, experience suggests that, sadly, many investors *will* get squeezed out of the markets at these levels and will then chase the market when it has already recovered.

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