

Lessons Learnt from the Global Financial Crisis

April 2009

This paper is a reflection on the last eighteen months of what has been termed the 'global financial crisis' ('GFC'), what lessons JANA has learned and what implications the GFC may have on financial markets and investing going forward. Many of the lessons learnt are not new but reminders, unfortunately sometimes painful reminders. It should be stated that the list below is not exhaustive and reflects one perspective on the GFC.



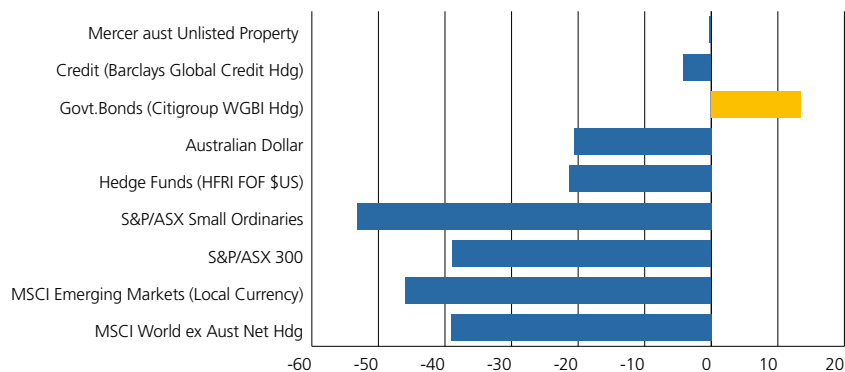
JANA

Lessons Learnt

The last eighteen months have been amongst the worst periods in financial market history and have caused great stress and anxiety on a truly global scale. The GFC has provided a once in a life time opportunity to test many financial assumptions that have become accepted over several decades.

- 1 Lesson one is not a lesson but a reminder** – Financial market implosions of the scale seen in the last few months of 2008 generally occur only once in a lifetime, so portfolios and investment strategies should not be built on the assumption that these types of environments are the norm.
- 2 The key to risk control is diversification** – Diversification has been synonymous with risk control within a balanced-style investment portfolio. The GFC has illustrated how asset classes and underlying exposures became more highly correlated than any back testing would ever suggest. This is largely due to back testing excluding “fat tails” of the distributions of return – the once in a lifetime events. Below is a simple table of returns to 31 December 2008 illustrating the point.

Returns Calendar 2008



Source: Database

The increased reliance on debt across almost all asset classes has amplified the impact of the recent liquidity crisis.

JANA believes the general premise of diversification reducing risk in an investment portfolio is still correct and the low leverage across financial markets post the GFC should improve the benefits of diversification; however the lesson learnt is you can never rely on historical correlations as the only means of determining risk within a portfolio. It is important to identify hidden risks. In the past 18 months these have included the systemic failure of the global banking system and extreme liquidity risk.

Lessons Learnt from the Global Financial Crisis

- 3 The importance of liquidity** – Many investors have been provided with the stark reminder that large allocations to illiquid investments provide risks in addition to standard market volatilities. By not retaining enough liquidity investors expose themselves to being forced sellers of assets in a highly illiquid market. For long term investors this can result in long term objectives being compromised to meet short term liquidity requirements. This can be in the form of unexpected cashflow requirements including currency hedging calls, capital calls from unlisted investments, members switching to conservative investment options or from underlying debt exposures not being available to complete projects or not being rolled.
- 4 Understand your members** – Over the past 18 months we have seen how various segments of the superannuation sector have behaved very differently. Some superannuation funds have seen a large movement from ‘growth’ investment options to cash or conservative investment options. This has had a significant impact on the asset allocation of some funds and has at times inhibited their ability to implement optimal investment strategies. Understanding the needs of members can help funds plan for potential changes in members’ allocations. Many funds have found a financial planning network useful in regards to education and member contact.
- 5 Increasing leverage into low risk assets changes the risk/return profile** – Using leverage to increase returns from low risk assets, until they meet a specified return target, can increase risk in ways which are not immediately obvious. JANA was always been aware that increasing debt did not result in a linear increase in risk and return. However the GFC has shown how quickly the risk can increase relative to return once leverage increases above what would have been previously considered moderate levels. To illustrate the point we can observe the returns from defensive investments that increased debt in an attempt to squeeze out higher returns: listed property, infrastructure and absolute return strategies. Over the medium term, lenders are unlikely to allow this over leverage of even defensive assets, however over the long term we may again see an environment where leverage is again over utilised.
- 6 When the environment changes dramatically, be prepared to make decisions** – The hesitation to change positions only recently implemented, even though the environment has changed significantly, has been a contributor to poor returns. It is a basic human instinct to support recent decisions made, as changing the decisions infers a mistake or failure, however when the environment changes materially from when the decision was made, and the new environment makes the decision inappropriate, be prepared to act decisively.
- 7 Be conscious of any imbedded biases within portfolios** – Any strong style or manager concentrations should only be implemented where a high conviction is held. In market disruptions, these can result in extreme performance outcomes and not always positive ones. Sometimes the long term strategy can be compromised by short term outcomes.
- 8 A well diversified absolute return strategy is not defensive in all markets** – Very few asset classes perform well during a liquidity squeeze and the majority of ‘absolute return’ strategies fall into this camp. The large level of funds invested into absolute return strategies especially with high levels of leverage meant that when leverage was withdrawn the door to exit positions was far smaller than required. As the GFC unfolded, the correlation between credit and equity strategies increased, which undermined the diversity of many multi strategy absolute return funds. In addition, the issue with counterparty risk amplified the difficulties in maintaining positions. The environment going forward where market participants and assets allocated to these strategies will significantly reduce, combined with a return to levels of market volatility and valuation dispersion more in line with historical levels should again provide opportunities in absolute return strategies.
- 9 During a dislocation in financial markets normal relationships often fail** – Many of the relationships that are used to construct diversified portfolios can fail in periods of severe market dislocation. This can be displayed in numerous ways but can cause standard fundamental analysis to be flawed in the short term. If these short term events are severe enough it can undermine long term strategies. So the lesson here is in an environment that is extreme such as the GFC, avoid concentrated positions and do not assume long term relationships will necessarily apply.

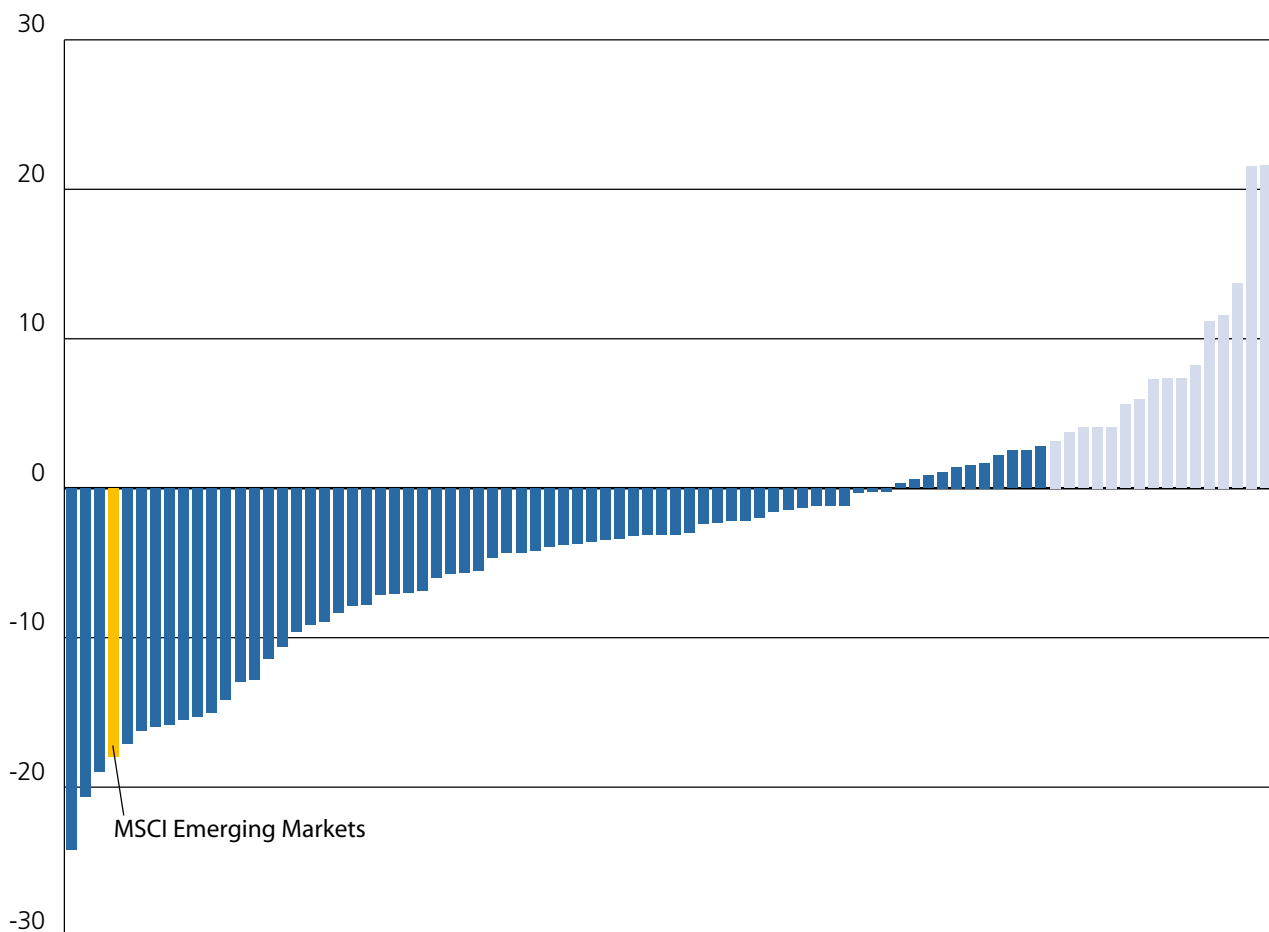
Examples are quality companies that have dependable income streams and are valued at conservative levels would be expected to outperform in falling markets. These stocks on a global basis have not outperformed in the past eighteen months. A combination of concentrated managers has not diversified risk in a similar way to a fewer number of diversified managers as concentrated managers often found 'opportunities in the same securities. Quantitative long short managers had the same signals working against them on both the long and short side, and consequently suffered significantly.

Refer to the chart below which provides active returns for the six months to 31 December 2008 for a universe of global equity managers. It reflects an environment where the vast majority of active international equity managers underperformed the Index, which is counter-intuitive.

10 Targeting tracking error can introduce rather than eliminate risk – Over the years preceding the GFC volatility was abnormally low, where funds targeted a minimum and maximum level of tracking error, many investment managers were encouraged to take larger positions than their strategy would otherwise dictate in order to bring portfolios into line with the expected tracking error. Consequently, when markets became highly volatile the risk of portfolios was amplified and potential losses increased. Investors should understand the nature of portfolios and the prevailing levels of volatility and valuation dispersion within markets and should concentrate on style consistency rather than meeting a predetermined tracking error.

11 The market is a rational allocator of capital – JANA has never believed the market is efficient and the past 18 months has emphasised the point.

FYTD Active Returns for period ended 31 December 2008



Source: Various manager returns

Lessons Learnt from the Global Financial Crisis

The Environment Looking Forward

To forecast the financial environment is extremely difficult but we have listed in order of probability what we see as some of the outcomes of the GFC.

Greater regulation

This is a given, with governments and central banks having to effectively bail out the private sector and consequently being owners of business, regulation will increase across most sectors and regions with a concentration in the financial sector. The risk of regional protectionism is a risk to global trade, however, as this was a major impediment to a recovery in the great depression world leaders have an incentive to keep trade flowing. The political risk within Europe is growing and includes the issues surrounding the central policy making of the European Union and how appropriate this is for individual countries.

Lower leverage

Lower leverage will be driven by the consumer and business wanting to de-lever and also by the banking system which is less inclined to lend. Governments are now in the business of making this transition slower and more controlled than otherwise would be case. As in all cycles one day we will once again see a re-leveraging environment, however this is unlikely in the foreseeable future. Certainly the day of opaque structured credit products seems to be over.

Lower economic growth

Governments around the world will need to deleverage after bailing out the private sector, and this will need to be primarily through higher taxes resulting in the potential for lower growth. Trend growth could be expected to lower over the next decade compared to the previous decade where the global economy benefited from low inflation and increasing leverage.

Higher inflation?

The potential for the massive liquidity injection provided by governments and central banks globally to add to long term inflation is a risk and not a risk that is currently being reflected widely. The short term concern over deflation has taken focus away from inflation and central banks will be hesitant to fight inflation for fear of risking any economic recovery.

Active Management will reward

In the coming years, active management is likely to add higher real returns and reduce real risk across investment portfolios as fundamentals start to drive investment returns. We believe that the chart illustrated on the previous page showing how the majority of active managers underperformed in the six months to 31 December 2008 could well be reversed over coming years.

Better returns?

Higher taxes and inflation are both negative for equities and fixed interest, however based on current valuations the probabilities of meeting long term average real returns is strong over the next decade. Buying recurring and dependable cashflows at low valuations which is currently possible over the long term is the best investment environment. There is always uncertainty in financial markets but large macro events do not occur frequently and generally there are no clear signals that these events are about to occur. The only way to protect against falling markets is to forgo returns in good years.

Summary

For all the disruptions and hardship the GFC has created there are some very basic investment principles that over the long term should continue to serve our members well:

- Buying dependable cashflows at cheap valuations is a successful formula for building long term wealth.
- Short term investing is a gamble which, like the casino, after transaction costs puts the odds with the house. Long term investing is part art and part science but with in depth research helps put the odds in favour of the investor.
- Protect the severe downside as far as practical; when the majority of capital is lost it is extremely difficult to recover this position even over the long term.
- Be patient and take advantage of the extreme investment opportunities when they arise.



JANA Investment Advisers Pty Limited.
JANA is a registered trademark.

Important Information

This research note is intended to provide general information only for wholesale clients and has been prepared by JANA Investment Advisers Pty Ltd ABN 97 006 717 568 (AFSL 230693) without taking into account any particular person's objectives, financial situation or needs. Investors should, before acting on this information, consider the appropriateness of this information having regard to their personal objectives, financial situation or needs.

JANA Investment Advisers Pty Ltd, Level 9, 530 Collins Street, Melbourne VIC 3000, Australia, is a member of the National Australia Bank Group of companies.