The TAMRIS Consultancy

Shorts – March 2009

A series of brief comments on relevant issues

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31 March - Before I go insane: sequence of returns risk

In response to recently quoted research from Russell Investments Canada Ltd.

Before I go insane:

The current market downturn is not a sequence of return risk - sequence of return risk is a risk associated with what many perceive to be the randomness of market returns - but a systematic risk associated with severe financial and economic imbalances.

Sequence of return risk is only a risk if you expose equity positions to short term market and economic risk.

You are exposed to this risk if you take systematic withdrawals from equity positions at all points in time in the market and economic cycle.

If you have a structured approach with a dedicated low risk asset allocation, where the maturity structure matches the size and timing of income and capital liabilities, and where the equity allocation consumption can be deferred for a time frame capable of dealing with significant market and economic risk (8 years or more) and a modelling approach that stress tests to determine a safe structure and withdrawal rate, you are not exposed to sequence of return risk.

Most analysis of sequence of return risks ignores the impact of asset management costs: high cost systematic withdrawal mutual fund solutions (even with a balanced asset allocation) pose a higher risk of depletion than a naïve 100% allocation to a low cost 100% equity ETF.

Just do the modelling!

But in a market moving towards zero, everything turns on its head: instead of eating up your bonds you should be consuming your equities.

Why oh why do we persist in calling the problem a sequence of returns issue when sequence of returns is not in fact a problem if a portfolio is properly structured? Presumably because it would appear to be an easily communicated risk against which to sell the solution you have to hand!

This is the same old trap Michelangelo considered when he said something to the effect that; "The greater danger for most of us lies not in setting our aim too high and falling short, but in setting our aim too low, and achieving our mark."

31 March - Bear market clues and economic cheerleaders: who is to blame?

A recent document on the current bear market by [Don Coxe of BMO]() gave a number of excuses for the financial service industry's omission in not working out in advance the recent crisis and market downturn: these were that a) they trusted the Wall Street banks to be smart enough to manage the risks and b) that Obama's policies have not worked out as well as expected and that the current stage is down to the current administration.

This is absolute “bollocks” as we would say in the UK: the risks to the financial, market and economic infrastructure were clear to anyone who cared to dig into structural domestic and global economic imbalances and the fundamental risks of unregulated and unfettered growth of the global OTC derivatives market place and broad money supply growth.

This was a disaster that should have been clear to the very, very many seasoned economists that are employed in the industry.

Obama is a sideshow and an easy target to deflect criticism. I would not say that the financial services industry was wholly to blame (Central banks pumped far too much liquidity in the system and regulators completely ignored the enveloping storm), but the industry went to the same party and drank from the same cup and chose not to leave when things started to get out of hand.

One can be forgiven for thinking that many economists (Not all) were merely cheerleaders. I have said for a long time (going back to the earl 1990s) that economic research from financial service's firms has an interest in the status quo and that this obscures the objectivity of much analysis. I would also criticise the "group think" mentality of many firms that deliver consensus arguments and views and that fails to break down the component thought processes that underpin the research and views of the many. Firms would be better placed providing minority opinions alongside consensus group think to give a better perspective of the issues and the options in the market place. By the time you deliver an average you have lost the depth and the definition; "you can drown in a river with an average depth of a foot".

26 March 2009 - You cannot spend your way out of debt!

A few pieces of positive US economic data (retail sales, housing, durable goods orders), a plan to take toxic assets and impaired loans off bank books, a looming and large stimulus package on top of concerted central bank action to revive credit markets, and many believe that the worst is behind us.

Merely increasing base money supply and unclogging the banking system (if indeed the current plans can do this) is not going to solve the structural economic imbalances that led to the problems in the first place: the "excess debt built up over the last 10 years and more" is still pretty much within a now further weakened system; this weakness will continue to hamper loan growth to exposed businesses and consumers for some time to come.

While stimulus is needed to keep the global economy alive while imbalances adjust, we must understand that a) economic stimulus will transfer capital to areas of the economy that are less productive and b) increased fiscal deficits will create a drag on future expenditure as governments will eventually need to raise taxation or cut expenditure to reduce deficits and, c) that excessive stimulus may bankrupt a nation, risk an inflationary spiral and defer the eventual time frame of a healthy long term recovery. Any quick recovery that we might see is unlikely to be a meaningful recovery.

The problems that led to the current downturn were due to excessive consumption in a number of key global economies, excessive asset focussed global money supply growth, excessive levels of consumer debt (The US in particular) and financial innovation that threatened to implode the global financial system when these imbalances start to collapse.

Areas of the world that had depended on global consumer imbalances have seen industrial production and exports collapse. These areas need to recover substantially for economies over dependent on consumers to rebalance without much more pain.

Merely reflating demand via government expenditure is not going to solve the problems that led to the crisis. US consumers need to consume less, they need to lower their debts, they need to save more and as such the economic adjustment still has some way to go: US personal consumption expenditure in the US is still close to 70% in the 4th quarter of 2008 and needs to fall closer to 64% of GDP to provide a better balance between savings, investment, production and consumption.

We clearly do not know how all this will actually unfold from this point on, but we should not be overly optimistic. Before the crisis struck, in the absence of global decoupling, the options were deflation and economic collapse or inflation and economic stagnation. That the crisis has been allowed to unfold for so before the introduction of concerted intervention means that the options available at the start are now degraded.

You cannot spend your way out of debt! If anything, we are at the end of the beginning, not the beginning of the end.

March 2009 – Bank Rescue Plan

The US government's toxic and impaired asset rescue plan intends to purchase some $500bn (and up to $1trn) of impaired real estate loans (legacy loans) and toxic assets (legacy securities) from US banks. The objective of this appears to be primarily one of taking illiquid problem real estate assets out of bank balance sheets and replacing them with liquid blemish free cash, which can be re-lent to consumers and businesses. A secondary objective appears to be one of providing liquidity to toxic securities so that they can be priced and eventually traded.

There remains many questions over the ultimate direction these plans will lead the market and the economy should they be successful in attracting the necessary bids from investors and asset transfers from banks:

- Where will money for the legacy loans come from? The FDIC is only guaranteeing the debt for the legacy loans.
- How long will Private Partnership Pools hold the assets? As long as the maturity structure of the underlying debt?
- Will these pools be securitised and sold to institutions? If more assets are to be taken on board then the debt underpinning these pooled funds may need to be sold on to release capital for new debt purchases?
- Will these pooled investment vehicles be traded on an exchange, will a transparent securitised debt market be developed? Ultimately these investments will need to be traded on a transparent exchange where institutional and private investors can price and trade.

The plan itself, as is, is dependent on economic recovery, since deterioration in economic conditions will further impact asset values, creating significant losses on these investments for US taxpayers. Deterioration in economic conditions will cause new loans to be impaired and further securities to fall in value.

There is no doubt that impaired and toxic securities risk the banking system's ability to provide credit to the economy and that the banking system needs to be rid of impaired and toxic assets, but this would be best served by letting existing shareholders and debt holders take the financial hit on these assets with the government taking to restructure and ultimately turn the institutions back into the market place.

Managers, shareholders and debt holders need to be wary of true risk/return relationships when making investments and management decisions: government bailouts that absorb risk on behalf of free market parties is the wrong way to go.

There is a very involved public debate on the issues of bank rescues and bad assets, and I would recommend that anyone involved in providing investment advice is up to date with these issues. Seriously, if you do not understand what is happening to the core financial system you will be unable to communicate anything meaningful to those you are advising. You should reference the US Federal Reserve, the UK's Bank of England and European Central Bank websites; also worth looking at are a number of blogs that are dealing with these issues, Willem Buiter's Maverecon and Nakedcapitalism are two to start with; the FT's Alphaville and the FT's comments section are also useful and provide a much larger blog reference pool.

March 2009 - Retail financial services' framework ill equipped and in need of change!

The trials and tribulations of the last 10 - 12 years have shown how incapable the retail financial services industry framework is in dealing with significant risk events and its ability to manoeuvre client income and capital security through such events. Much needs to be changed!

TAMRIS has been spending much of the last 3 months researching and analysing industry issues in a set of reports soon to be released.

March 2009 – Is "buy and hold" dead?

One of the many issues that needs to be confronted is the narrow belief that capital can be invested at any point in time with regard to valuation and economic risks and that over time, everything, in the context of achieving normal/average long term average real returns, will be all right.

While the importance of discipline and structure remain as relevant as ever before (en masse market timing is also not an actionable prescription), the simple retail mantra of buy and hold, for those with short to medium term liabilities (income and capital demands), is inappropriate.

The management of income and capital security should be sensitive to economic and market risks: how a portfolio structure manages this risk dynamically over time while retaining discipline and structure is something which portfolio theory and the industry need to come to grips with.

As an aside, it is worth noting that while buy and hold is a long term message passed to clients, to hold the course, many portfolios are inappropriately churned even within this context.

Please note that these comments do not support an active trading stance, but a structured response to the higher risks and lower returns on asset classes as market and economic cycles peak and as significant to severe structural imbalance build up.

March 2009 – Variable Annuities + GMWBs

Variable annuities with Guaranteed Minimum Withdrawal Benefits are designed to provide investors with downside protection for withdrawals over their lifetimes. Many insurers are currently exposed to the downside risks in the market place to the extent that their ability to meet future liabilities without a recovery in share prices is in doubt.

If an insurer is at risk of not being able to meet current liabilities, if markets remain at current levels, then investors should not be purchasing VAs+GMWBs from these companies, because they will be unable to guarantee the downside protection. Investors would be better off taking the full risk and paying lower charges. Advisors recommending VAs+ GMWBs need to be aware of this risk.