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Managing wealth in financial crisis

Portfolio managers need better education and training as tasks are more demanding now, write **FRANCIS KOH** and **KLAUS SPREMANN**

HAVING a diversified investment portfolio has not cushioned high-net worth individuals and billionaires from huge losses in the global financial crisis. Even Warren Buffet, the investment wizard, took a big hit. His flagship company Berkshire Hathaway lost half its value between Dec 11, 2007 and Nov 20 this year. Why? Because all the different markets will now become highly correlated and exhibit similar co-movements – downwards.

Prior to the crisis, the stock market was liquid, vibrant and robust. Many high-net worth individuals and institutional investors saw it as a safe way to increase their wealth over the long run. Some even borrowed to leverage their positions to capitalise on this historical "wisdom". Others followed the dictates of Modern Portfolio Theory (MPT) to diversify their wealth across different asset classes to avoid concentrated bets on a few securities.

MPT was pioneered by Harry Markowitz, William Sharpe and other Nobel Prize winners. It posits the need to focus on the trade-off between risk and return. MPT also teaches that "portfolio risks" go beyond "market risks". There are significant liquidity risks which have to be managed, and liquidity risks are embedded in the global financial system.

The current crisis may be traced to particular tracts within the financial system. The media first reported signs of distress in 2007. The possibilities of housing loan problems and a sub-prime crisis were mentioned. These problems lingered on.

Increasingly, the whole financial system was severely stressed in the ensuing months. Banks tumbled, global stock markets crashed sequentially and in instalments.

The malaise of the financial world exacted its toll on the real economy. No stock market or physical market around the world was spared. Accordingly, manufacturing companies are witnessing lower demand as the global economy slows. Trading companies face credit problems while shipping companies have less cargo to move.

It is apparent that the current financial crisis, originating from the housing and credit markets in the United States and Europe, has crossed borders to infect all countries.

Why has this happened? Over the years, markets became more interrelated. A globalised world suffers from inter-connectedness; a market failure in one geographical market has a knock-on effect on other markets in other developed and developing economies.

Among the techniques and instruments which have amplified this interrelation are securitised and structured products, and credit default swaps. The returns and payments associated with these derived products depend on the returns and payments of their underlying assets, which could again be structured products of some form.

Many financial products are sound provided their underlying worth is holding well. Funds have been constructed out of other funds, which again were made of contracts. In the end, nobody could say how far a small disturbance in one product could spread, and how other segments would be affected.

Only a few years ago, several investment markets were fairly independent. For example, real estate, stock, fixed income, commodity and private equity markets primarily follow their own developments. These days, financial innovations swiftly connect these markets. Consequently, many of these asset classes are linked and inter-related. They no longer exhibit independent price movements.

It should be noted that these worldwide connections have many benefits. If an investor wants to attain a particular financial position, there is more than one way to construct it. With innovations and financial engineering, there are many ways to create products which meet the needs of investors. Prices are also more competitive. Much more information is available to investors.

Many of these benefits are rooted in the capability of the financial engineers to connect across physical products and geographical markets.

Metaphorically speaking, the modern financial system is like a huge circus tent which gives protected space for a large array of activities. Such a tent is fairly stable because if one pillar becomes a bit wobbly, it will be kept in place by the other pillars.

Nevertheless, it can happen that if one pillar falls, it may pull the others down too, although this may be a very rare event. When all the posts are lying on the ground, a tent cannot be pitched by erecting one post after the other. They all must be raised simultaneously.

The property market, credit, money and stock markets must function well together with the real economy. The interrelation of financial and physical markets makes the situation so different from former crises, such as the 1997 Asian financial crisis, which was "rescued" by an injection of US$40 billion from the International Monetary Fund. In the current crisis, successive funding by many countries, including the US$700 billion package from the US government, is still not seeing the expected results.

Yet, the interrelation of financial markets is bad news for the diversified portfolio investor. In normal circumstances, the posts of the tent may move independently with the wind. In fact, the tent remains stable even if the pillars are bouncing. However, if the wind escalates to a storm, and if the storm becomes too strong, all the connected pillars would suddenly move in the same direction. For the portfolio investor in this situation, the bad news is that diversification will not work when he needs it most.

Most investors take the liquidity of financial markets for granted. Liquidity is provided by other investors when markets are functioning well. Liquidity diminishes when markets fail. It vanishes when interrelated markets fail altogether. Why so? Because, if all markets are intricately woven into a global financial market, any failure in one market affects all other markets at the same time.

MPT functions well under normal windy weather conditions. It fails miserably in a universal storm which we have recently encountered. In that event, liquidity is unavailable despite all the careful diversification that has been put in place. When there is a lack of liquidity, security prices fluctuate violently as investors panic or transact to cover their liquidity needs.

Brokers often focus on the weather for the short term, often in terms of days. They forget that there is a probability, albeit very small, that the global weather can remain stormy and windy for a prolonged period – and the whole marquee may fall, with no liquid markets left for investors to transact. Investors who use the portfolio approach are normally investing for the long haul. Nevertheless, they also need shelter in any storm. The importance of a well-constructed financial shelter depends on the individual's personal situation.

Does he have other resources? To what degree does he need cash in the short term? How risk-averse and flexible is he? Quite different from security brokers, a wealth manager takes care of the personal aspects of his client. He seeks to create a secure financial position for his client even if the financial market suddenly hits a storm.

Wealth managers advise their clients on the comparative advantages of different asset classes. More importantly, they advise their clients to switch regimes from one asset class to another, from stocks to commodities or to cash. This professional advice requires analytical tools to be applied effectively. Competent advice also demands technical knowledge and expertise.

Portfolio management in its simplistic form has become ineffective during the present crises. The lesson of a globally connected world is that naive portfolio diversification is not sufficient – and may even be impotent. Additionally, liquidity can vanish virtually overnight. A storm in one segment, if sufficiently large, can easily spread to the other segments of the financial system.

The current crisis shows that investors must move beyond modern portfolio theory. Competent wealth managers are needed to provide holistic investment advice to clients who face a complex world of changing weather conditions.

Clients have diverse needs, risk appetite and return requirements. Wealth managers are needed more than ever before. But the new tasks are more demanding and require better education and training. There is a demand for better-equipped wealth managers in a globalised world of finance. Finance and banking are very necessary in our modern world, but now they require more knowledge than before. More education is required, not less.

After the current crisis has settled, banking, wealth management and other financial services as an industry will offer more employment positions for young people, not less.

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