

## Extra-ordinary times, extra-ordinary actions required?

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The third quarter of 2008 has confirmed more than ever that we are living in extra-ordinary times. Efforts by central banks to avert the sub-prime contagion failed miserably and in the space of a couple of weeks Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, Wachovia, AIG and others were either sold, went into liquidation or nationalised. Furthermore, an unprecedented bail-out rescue package has been proposed by the US Treasury and the Federal Reserve, where they plan to pump \$700 billion to support the ailing banking system. This plan was initially rejected by the US House of Representatives.

The South African political situation remains in turmoil since Judge Nicholson's ruling, which provided an excuse for the African National Congress' National Executive Committee recalling President Thabo Mbeki and appointing Kgalema Motlanthe.

### **What does this mean for investors? Does it require extra-ordinary action from them?**

Nic Andrew, Head of Nedgroup Investments shares his views on the crisis, what caused it, and what investors should be doing.

### **What caused the current international banking crisis?**

There are a number of reasons cited for the international banking crisis. They broadly follow the following themes:

- inappropriate and lax access to credit to those who should not have been allowed to borrow
- the re-packaging of these poor quality loans by investment banks who sold them to investors in desperate search of yield
- the excessive leverage of the investment banks
- the credit agencies who rated these instruments incorrectly and without a proper understanding, and,
- poor transparency and regulation.

Falling US property prices were the first catalyst that started to show the cracks. Property owners who could not afford their repayments, could no longer rely on rising property prices to bail them out. What started as a sub-prime crisis (poor quality loans crisis), quickly spread into a general credit crisis - banks no longer trusted each other and refused to lend to one another. Liquidity, the life-blood of the capitalist system, was squeezed out of the system. This had dire knock-on effects and central banks (the US Fed in particular), have been forced to act decisively and materially to avert a complete meltdown.

While the latest proposed bail-outs and rulings (including banning short-selling), have provided some short term relief, and should restore some confidence in the financial system, it is unlikely that all the bad news is over, or that the global economy will recover quickly.

### **How does this international banking crisis compare with previous crises?**

This crisis is very serious indeed. Three of the five big investment banks in the US no longer exist and the other two are de-leveraging and changing their status to commercial banks. The extent of the Fed's proposed bail-out (\$700 billion) is unprecedented.

The crisis entered a self fulfilling downward spiral where asset prices were being written down, impacting the capital bases of banks who were struggling to raise fresh capital, resulting in a lack of confidence and further de-rating.

Interestingly though, to date, non-financial US companies (especially exporters) have continued to perform above expectations. The Fed's actions are a desperate attempt to prevent the financial crisis spilling over into the rest of the economy. Clearly some level of contagion is inevitable as bankers lose their jobs, spend less and as asset prices plummet (houses and equities in particular), consumers feel less wealthy and are less inclined to spend.

### **What exposure do South African companies have to sub-prime?**

South African companies have relatively low direct exposures to sub-prime. South African banks have remained relatively unscathed, partly as a result of exchange controls, and partly as a result of tougher monetary policy and legislation.

The greater issue probably relates to the indirect impact of the fall-out. Slowing economic growth, lower commodity prices and recession (in the economies of our major trading partners), will impact on South African exports, growth and sentiment. The extent of the impact in all likelihood depends on how successfully the Fed is able to restrict the crisis to the financial sector.

### **What has been the impact on asset prices?**

The impact has been severe. Equity indices around the world have dropped significantly (more than 20%) with certain sectors (particularly financials) and countries (such as China) falling by more than 50%. Property prices have also softened, particularly in the US and the UK. Many commodities have also declined materially on fears of slower world economic growth. In short, there has been very little place to hide as investors have been in a hurry to take risk off the table.

### **What should investors do, and how does one avoid making an inappropriate decision?**

Sensational headlines make it very difficult to remain unemotional. There is a very natural reaction of fear of the unknown and of regret that you did not disinvest before any major setback. Investment decisions made in panic and without proper thought are generally destructive.

It helps to have a clear, documented and sensible investment strategy. This should detail your objectives, timeframe and a realistic assessment of the risk you are required to accept to achieve the objectives set. Risk and return are closely related, and to have objectives of anything more than cash require an acceptance of risk. It is important to acknowledge this risk before you invest, to avoid incorrect action at the time of heightened emotion.

The benefits of a diversified portfolio (as a risk reducer) are evident and investors should ensure they have a spread of asset classes, industries, stocks and currencies in their portfolios.

Very often the best thing to do in volatile markets is to remain level headed and, depending on your circumstances, do nothing or look for the real investment opportunities that others' panic inevitably creates. You should only change your investment strategy when either your objectives or personal circumstances change.