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Unavoidable systemic risk 12 Jul 2007 04:21 PM

by Alan Rohrbach

Along with LEX duly noting both the resilience and risks evident in credit markets, the diverse perspectives from two highly qualified sources in Tuesday's FT was striking. Front page comments from Citigroup's Mr. Prince were undoubtedly accurate. Liquidity rushes in until... "At some point, the disruptive event will be so significant that instead of liquidity filling in, the liquidity will go the other way."

Indeed, equity bull market 'long tails' (late phase trend extensions) are so prevalent as to have fostered that cliché. Yet, there always seem to be those who become so entranced with the markets' ability to withstand individual impacts as to convince themselves that it really is "different this time." The nature of the trends across intermediate term cycles may seem different in duration or magnitude; yet that is simply how the market fools the uninitiated into believing it's different.

In truth, it never is. The two sets of abiding laws which can not be changed are those of the economic cycle and human nature. In fact, the latter is a goodly part of why things go the other way so definitively once the trends reverse, and the bubbles pop.

The other observation which is also very accurate is the comment from the estimable Mohamed El-Erian ("How to reduce risk in the financial system", July 10.) He is rightfully worried about how all of the recent extensions of financial engineering on both the equity and especially the debt side have landed quite a few exotic investment vehicles in portfolios of those ill-equipped to understand them. His assessment is that much greater regulation is necessary to protect the public's insurance and pensions.

On past form, good luck. The dilemma gets back to human nature. Once the bull market continues long enough for folks to lapse back from fear to greed, the public forgets their risk aversion. That can only return later as recrimination over losses. I noted in a major report a couple of years ago that bubbles repeat every generation, and this one seems to be different only in that it is occurring so quickly in the wake of the major cycle-ending Dot.Com Bubble bursting back in 2000.

Yet, the dissection of the rationale behind repeated bubbles is much the same insofar as "…whole cultures do not learn the lessons of financial history, because each generation's formative experience of necessity cannot include the previous thirty year (more or less) economic and investment cycle." "In the most cynical sense, about every thirty years or so the market has a new batch of suckers willing to invest (emotionally as well) in the idea that it is 'different this time,' prior to relieving them of a significant portion of their net worth."[1]

In an upside down parody of Churchill's praise for RAF defense of Britain during the darkest days of World War II, this is more likely to end up a matter of, "Never was so much owed to so many by so few"; with almost no chance of even modest recovery, due to the clear risk disclosure in the prospectus for each exotic instrument.

Mr. Prince is undoubtedly right that "the liquidity will go the other way" at some point. How retail investors in pension funds, insurance policies or annuities protect themselves against managers invested in exotic instruments that will suffer in the crunch is highly problematic. Unfortunately, who were the best managers either through circumspection or clever hedging of risks will only be apparent after a major asset price correction. As will those who were not.

1 1970's Redux: Son of Stagflation, Institutional Trend Insight, March 2005, Page 2.

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