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Seven lessons from the Global Financial Crisis for investors

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Key points

> The key lessons for investors from the Global Financial Crisis (GFC) are that: there is always a cycle; while each cycle is different, markets are pushed to extremes of valuation and sentiment; high returns come with higher risk; be sceptical of financial engineering or hard-to-understand products; avoid too much gearing or gearing of the wrong sort; the importance of proper diversification; and the importance of asset allocation.

Introduction

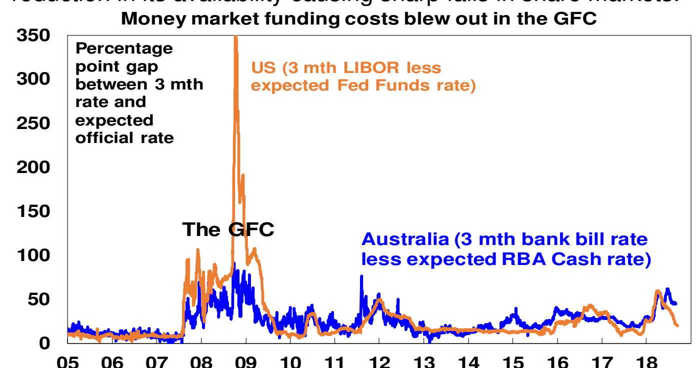
The period August to October is a time for anniversaries of financial market crises – the 1929 share crash, the 1974 bear market low, the 1987 share crash, the Emerging market/LTCM crisis in 1998, and of course the worst of the Global Financial Crisis in 2008. The GFC started in 2007 but it was the collapse of Lehman Brothers on 15 September 2008 and the events around it which saw it turn into a major existential crisis for the global financial system. Naturally each anniversary begs the question of can it happen again and what are the key lessons. And so it is with the tenth anniversary of the worst of the GFC.

A brief history of the GFC

The events around the failure of Lehman Brothers and the GFC have been done to death. But here's a brief history. It was the worst financial crisis since the Great Depression. It saw the freezing up of lending between banks, multiple financial institutions needing to be rescued, 50% plus share market falls and the worst post-war global economic contraction. Basically, the environment of low interest rates prior to the GFC saw too many loans made to US homebuyers that set off a housing boom that went bust when rates rose and supply surged.

- 40% or so of loans went to people with a poor ability to service them – sub-prime and low doc borrowers. And many were non-recourse loans – so borrowers could just hand over the keys to the house if its value fell – "jingle mail"!
- This was encouraged by public policy aimed at boosting home ownership and ending discrimination in lending. Some extolled the "democratisation of finance"!
- It was made possible by a huge easing in lending standards and financial innovation that packaged the sub-prime loans into securities, which were then given AAA ratings on the basis that while some loans may default the risk will be offset by the broad exposure. These securities were then leveraged, sold globally and given names like Collateralised Debt Obligations (CDOs). But after securitization there was no "bank manager" looking after the loans.
- This all came as banks were sourcing an increasing amount of the money they were lending from global money markets.

This stopped in 2006 when poor affordability, an oversupply of homes and 17 Fed interest rates hikes saw US house prices start to slide. This made it harder for sub-prime borrowers to refinance their loans after their initial "teaser" rates. So they started defaulting, causing losses for investors. This caught the attention of global investors in August 2007 after BNP froze redemptions from three funds because it couldn't value the CDOs within them, triggering a credit crunch with sharp rises in the cost of funding for banks – evident in a surge in short term borrowing rates relative to official rates (see next chart) - and a reduction in its availability causing sharp falls in share markets.



Source: Bloomberg, AMP Capital

Shares rebounded but peaked around late October 2007 before commencing roughly 55% falls as the credit crunch worsened, the global economy fell into recession, mortgage defaults escalated, and many banks failed with a big one being Lehman.

The crisis went global as losses magnified by gearing mounted, forcing investment banks and hedge funds to sell sound investments to meet redemptions which spread the crisis to other assets. The wide global distribution of investors in US sub-prime debt led to greater worries about who was at risk, with the loss of trust resulting in a freezing up of lending between banks and sky-high borrowing costs (see the previous chart). All of which affected confidence and economic activity.

The cause of the GFC lay with home borrowers, the US Government, lenders, ratings agencies, regulators, investors and financial organisations for taking on too much risk. It ended in 2009 after massive monetary and fiscal stimulus along with government rescues of banks. But aftershocks continued for years with sub-par growth and low inflation into this decade. From an economic perspective the GFC highlighted that:

- **Fiscal and monetary policy work**. There is a role for government, central banks and global cooperation in putting

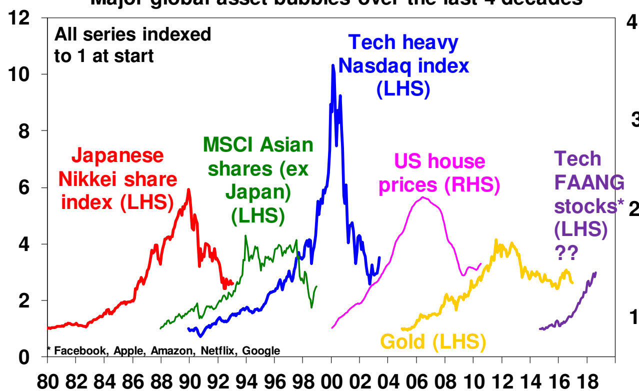
free market economies back on track when they get into a downward spiral. (While some have argued that easy money just benefitted the rich, doing nothing would have likely ended with 20% plus unemployment and worse inequality.) Hopefully there will be the same common sense 'do whatever it takes' approach again if the need arises.

- **The return to normal from major financial crises can take time** – in fact a decade or so according to a study by Kenneth Rogoff and Carmen Reinhart - as the blow to confidence depresses lending and borrowing and hence consumer spending and investment for years afterwards. The key is to allow for this and not turn off the policy stimulus prematurely, but also to avoid thinking it is permanent as the muscle memory does eventually fade.
- **"Stuff happens"** - while after each economic crisis there is a desire to "make sure it never happens again", history tells us that manias, panics and crashes are part and parcel of the process of "creative destruction" that has led to an exponential increase in material prosperity in capitalist countries. The trick is to ensure that the regulation of financial markets minimises the economic fallout that can occur when free markets go astray but doesn't stop the dynamism necessary for economic prosperity.

Will it happen again?

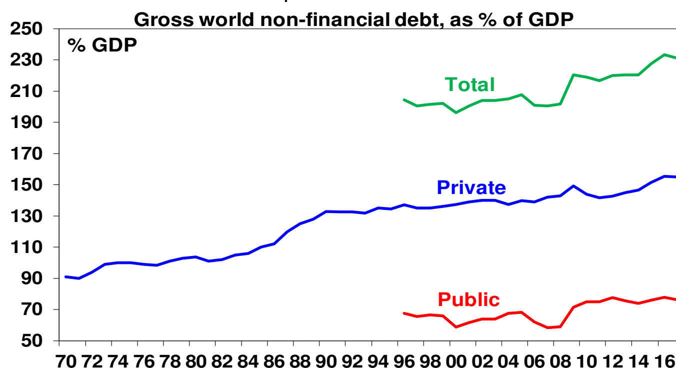
History is replete with bubbles and crashes and tells us it's inevitable that they will happen again as each generation forgets and must relearn the lessons of the past through another bubble based on collective euphoria about some new innovation. Often the seeds for each bubble are sown in the ashes of the former. Fortunately, in the post-GFC environment seen so far there has been an absence of broad-based bubbles on the scale of the tech boom or US housing/credit boom. There was a brief surge in gold and some commodity prices early this decade but it did not get that big before bursting. Bitcoin and other cryptos were another example but they blew up before sucking in enough investors to have a meaningful global impact. E-commerce stocks like Facebook and Amazon are candidates for the next bust but they have seen nowhere near the gains or infinite PEs seen in the late 1990s tech boom.

Major global asset bubbles over the last 4 decades



Source: Thomson Reuters, Bloomberg, AMP Capital

Post a GFC related pull back, global debt has grown to an all-time high relative to global GDP posing an obvious concern. However, this alone does not mean another GFC is upon us. The ratio of global debt to GDP has been trending up forever, much of the growth in debt in developed countries post the GFC has been in public debt and debt interest burdens are low thanks to still low interest rates in contrast to the pre-GFC period. Furthermore, the other signs of excess that normally set the scene for recessions and associated deep bear markets in shares like that seen in the GFC are not yet present on a widespread basis. Inflation is low, monetary policy globally remains easy, there has been no widespread overinvestment in technology or housing, and bank lending standards have not been relaxed as much as prior to the GFC.



Source: IMF, Haver Analytics, BIS, Ned Davis Research, AMP Capital

Moreover, financial regulations have tightened with banks required to have higher capital ratios and get more funds from their depositors. Much of the surge in debt post the GFC has been in private emerging market debt rather than in developed countries suggesting emerging markets are at greater risk.

Another economic crisis is inevitable at some point, but it will likely be very different to the GFC.

Seven lessons for investors from the GFC

The key lessons for investors from the GFC are as follows:

1. **There is always a cycle**. Talk of a "great moderation" was all the rage prior to the GFC but the GFC reminded us that long periods of good growth, low inflation and great returns are invariably followed by something going wrong. If returns are too good to be sustainable they probably are.
2. **While each boom bust cycle is different, markets are pushed to extremes** - with the asset at the centre of the upswing overvalued and over-loved at the top and undervalued and under-loved at the bottom, which for credit investments and shares was in first half 2009. This provides opportunities for patient contrarian investors to profit from.
3. **High returns come with higher risk**. While risk may not be apparent for years, at some point when everyone is totally relaxed it turns up with a vengeance as seen in the GFC. Backward-looking measures of volatility are no better than attempting to drive while just looking at the rear-view mirror.
4. **Be sceptical of financial engineering or hard-to-understand products**. The biggest losses for investors in the GFC were generally in products that relied heavily on financial alchemy purporting to turn junk into AAA investments that no one understood.
5. **Avoid too much gearing and gearing or the wrong sort**. Gearing is fine when all is well. But it magnifies losses when things reverse and can force the closure of positions at a loss when the lenders lose their confidence and refuse to roll over maturing debt or when a margin call occurs forcing an investor to sell just when they should be buying.
6. **The importance of true diversification**. While listed property trusts and hedge funds were popular alternatives to low-yielding government bonds prior to the GFC, through the crisis they ran into big trouble (in fact Australian Real Estate Investment Trusts (REITs) fell 79%), whereas government bonds were the star performers. In a crisis, "correlations go to one" – except for true safe havens.
7. **The importance of asset allocation**. The GFC reminded us that what matters most for your investments is your asset mix – shares, bonds, cash, property, etc. Exposure to particular shares or fund managers is second order.

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