

# Bubbles, Myths and Rational Optimism

By Tony Ashton

The recent banking and credit crisis adversely affected most investment assets...

- Property prices collapsed and new projects were either cancelled or postponed.
- Global stock markets fell.
- The normally safe haven of government bonds became mired in uncertainty as the credit worthiness of countries like Greece, Ireland and Portugal was called into question. (Even the UK was regarded by the International Monetary Fund and the World Bank as a possible future risk.)
- Companies looking to raise finance through bond issues suddenly found that they had to offer greater returns, raising the cost of borrowing.
- Low interest rates have left many savers having to spend capital to meet their income requirements.

During this time, mainstream media has revelled in reporting on the declining economic situation and taking pleasure in “bank bashing”. So for the claimant receiving a lump sum settlement, the prospect of choosing the right investment strategy is more daunting than ever.

In this article, Tony considers whether the situation is as bad as it would appear, or if there are genuine green shoots of recovery.

## Bubbles

### It started with equity...

Asset bubbles are not new and the recent one has its roots in the stock market bubble of 2000. During the eighties and the nineties, the baby boomer generation was enjoying the peak earnings and savings years. Equity investment was the main beneficiary and stock markets flourished under the constant flow of new money. Pension funds and insurance companies were active participants and returns were so strong that many employers were advised to take pension contribution holidays whilst some insurers offered attractive policy bonuses based on future investment returns.

At the beginning of this decade, many baby boomers were nearing or entering retirement and as a result, there was a significant shift away from equities, resulting in a marginal fall in equity values in 2000. The fall was significant enough however to cause liquidity problems for many pension funds and insurance companies such as Equitable Life. Regulators were forced to intervene and imposed stricter liquidity requirements that forced them to sell equities in favour of lower risk assets. The huge equity sell-off saw stock markets tumble and the equity bubble that lasted almost uninterrupted for 25 years had finally burst.



## And then property...

The enormous amounts of money that came out of equities required reinvestment and the main beneficiary was to be the debt market.

Inflation had not been a problem for many years, partly due to the integration of emerging markets into the global economy, therefore interest rates had remained low. Banks and other financial institutions began looking at ways to lend the vast sums now available to them and to maximise their profit margins.

The property market bubble had been growing for several years - fuelled partly by the emergence of property speculators - and it seemed sensible for banks to lend money to people buying property as the loan could be secured.

As banks made 100% loans available, the sub prime mortgage market was to flourish, introducing low start repayment plans and the self-certified income mortgage - more commonly known as "lie to buy". People with adverse credit histories were also encouraged to become home owners.

Sub prime loans enabled the banks to levy higher charges and interest rates in the belief that if clients defaulted in the future, the property would have increased sufficiently to cover the outstanding debt. More profit ... limited risk.

A bank's credit worthiness is determined by the quality of its lending book. If it is known to have a high exposure to sub prime debt, its credit rating may fall making it more difficult and expensive for it to raise funds on the money markets. In order to retain a high credit rating, strategies were devised to offload most of the sub prime loans onto other unsuspecting investors and financial institutions.

The Collateralised Debt Obligation (CDO) was created and sold into the market as a high income paying investment plan. The fund was a rather complicated structure incorporating sophisticated investment assets but was, unbeknown to investors, underpinned by sub prime mortgage debt. Premiums paid by unsuspecting financial institutions and investment banks were immediately invested back into new sub prime loans.

Government supervision was somewhat relaxed during this period as the financial industry was providing both jobs and tax revenues. The Financial Services Authority had replaced the Bank of England as the UK's banking regulator and, as we were later to discover, wasn't quite up to the job.

## All bubbles burst eventually

With 5% of sub prime mortgages in the US defaulting before the first repayment was due, this market collapsed quite spectacularly in 2007. As the number of defaults increased there was concern amongst bankers about the extent of their exposure to "toxic debts". Banks immediately restricted further lending as they tried to assess their liabilities and the lack of finance caused the property bubble to burst. Falling property prices also meant that the banks would be unable to recover mortgage loans by selling repossessed properties. Banks that had invested in CDOs suddenly found that the investment plans were now worthless.

The credit bubble burst causing the property bubble to burst, and the lack of available credit and finance caused another fall in equity values.

It is no secret that it has taken considerable government intervention to rescue the global banking system.

## Myths

Not only is the investor faced with the uncertainty of highs and lows. The financial services industry has a reputation for putting its own interests ahead of the needs of individual clients in order to continue to sell products. They try to appeal to investor sentiment and are happy to perpetuate investment myths.

As most potential investors are concerned by recent events, the development of “No Risk” or “Low Risk” products has flourished. But while promises of guarantees and institutions willing to take risk on behalf of clients may appeal to the risk-averse investor, they are a flawed concept.

Most settlements are compromised so claimants' damages have to work harder to provide the long term security they need. Recommending products that are based on past events, such as cautious investment funds, may appease immediate concerns about volatility risk but not necessarily the issue of funds growing sufficiently to meet future requirements. Most certainly, that which makes for an easier sell does not equate to meeting the best interests of the claimant in the long term.

For example, advising someone to invest when asset prices have fallen is not easy, but doing so usually reaps the long term rewards that the investor really needs.

It has never been more important to ensure that a claimant's individual requirements are considered before an investment strategy is put forward. Not meeting future needs is just as risky as volatility so individually tailored portfolios should be created to meet long-term objectives whilst respecting the client's risk profile.

## Rational Optimism

One of many asset bubbles, the current credit crisis has been the worst since the great depression of the 1930s. Without considerable government support it would have been catastrophic. Economies will take time to recover. Higher taxes and lower public spending will be required in the future.

But despite this, the same investment opportunities are available to the claimant investor as they were before. Consider the following...

- Regulation will become tighter, just as it did for the accountancy profession following the collapse of Enron and Anderson Consulting. Governments may intervene earlier to prevent bubbles from forming, something that recently happened in China as the government ordered banks to limit lending due to fears of a growing property bubble.
- Global growth will continue and is not going to be halted by a short term lack of funding. China, India, Latin America and Africa are all at various stages of development and growth in these regions is not only sustainable but inevitable. As they develop their infrastructure, they develop their economy, which in turn provides employment, education and business growth opportunities. The things that are taken for granted in the west - mobile phones, iPods, designer clothes, entertainment systems - become sought-after items. Global companies such as Vodaphone are already making more than half of their profits from developing economies. BMW sold more cars in Asia and the Middle East last year than they did in Europe.
- Banks have not only survived but many are already returning to profit. Developments in technology, media and medical science are advancing at an unprecedented pace and the United States and Europe will continue to lead in these areas.



- The equity losses of 2008 were recovered in 2009, and the UK FTSE 100 Index of leading companies fell by 29% in 2008 and increased by 30% in 2009.
- Good quality companies will continue to make profits which can be shared with investors through a combination of dividend income and share price growth. Equities offer rising income and capital growth potential over the medium to long term helping claimants meet future income and expenditure requirements.
- Governments and companies will continue to raise funds via the bond market, which can offer attractive returns to meet income requirements.
- Although interest rates are likely to remain at low levels for the foreseeable future, cash will remain an important part of a claimant's portfolio to provide an easily accessible contingency fund.

### The Bright Side...

Asset bubbles will undoubtedly appear from time to time, although if lessons are learned future returns could be more modest but also more sustainable. The financial services industry will no doubt continue to perpetuate myths and appeal to investor sentiment in order to sell products rather than providing meaningful and constructive investment advice. However, asset prices offer excellent long term value based on global growth and the inevitable economic recovery. And with the right advice, the claimant with damages can, and should, be rationally optimistic.

---

**"The Settlement Specialists"**  
For all enquires visit [www.amwealth.co.uk](http://www.amwealth.co.uk)  
Tel: 0161 618 1060