

Five questions about the current market crisis:

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Today I am going to address questions that are relevant with respect to the credit crisis which has besieged markets. They are all topical in that they have been asked of us by our clients.

1. Were asset managers aware of the risks?

Most market participants understood that deep seated risks existed in the global financial system. Notional debt instruments, conduit paper, credit default swaps, excessive leverage, overvalued property markets and commodity excesses are a few of the issues which we have written about in the Alphen Angle in the past. We were hardly alone; there have been many competent asset managers that have considered such risks and communicated these publicly.

2. Should the asset management community not have predicted the collapse and positioned portfolios totally in cash?

As mentioned above, many asset managers have understood where things could go wrong for financial markets, but these risks have been spoken about since the mid 1990's and markets have generated huge returns for investors since then. In order to have escaped any capital losses, a manager would have been required to time the fall almost to the day. Any earlier exit from the market would have involved immeasurable pain considering how aggressively the markets have rallied over the last couple of years. Thus, to have achieved perfect timing, even within a year, would have been utter luck.

One of the most relevant quotes that in my opinion best depicts short-term forecasting originated from a university economist speaking at an international finance conference in the US and is unfortunately anonymous. "My father was in the import-export business and he used to ask me to predict exchange rates. It's an experience that did not bring us much closer". At Alphen, we are constantly reminding our clients that short-term forecasting is best described as a 'random walk'. No distinguishable pattern is observable in randomness, it is impossible to predict. This is precisely the problem with stock markets, over short periods of time, shares produce random behavioural patterns as they are under the control of the human psychologies of fear and greed. Shares in the long-term are very predictable as they merely follow the profit profiles of companies. Great companies grow profits in excess of inflation in the long-term. It is very important for investors to understand that no asset manager can predict short term psychological swings in human behaviour and hence time markets.

3. Are markets now unsafe and is it not best to exit all my equity positions?

Similar to other asset managers, at Alphen we seem to consistently fail to convince our retail and certain of our institutional clients that markets are most unsafe when they are rallying hard. The irony is that when investors feel most comfortable, which corresponds to when they are making money, the margin of safety in a market is normally diminishing.

Stock markets are safest when share prices have fallen hard and far. This does not imply that equity prices can not fall further but it does suggest that when prices of blue chip, reliable companies have already collapsed by 50%, the chances of another 50% is significantly diminished.

Evidence of this can be found throughout history and Wednesday's Alphen Angle written by Mark Seymour speaks to exactly this point.

4. Are my unit trust investments safe if banks are failing?

Unit trusts do not reside on the balance sheets of banks; they are separate legal entities that are ring-fenced. Unit trusts are strictly monitored by various levels of compliance and each unit trust in South Africa has a registered trustee that must oversee all activities within the fund on a daily basis. Furthermore, unit trusts are governed by Cisca - the Collective Investment Scheme Control Act, and the industry is regulated by the Financial Service Board and overseen by the Association of Collective Investments. Many investors are particularly worried about money market unit trusts as these usually house their 'safe assets'. These too are not housed on the balance sheets of banks or on the balance sheets of the asset managers that manage these funds and may not be accessed by the managers of the funds for self use. Ironically, bank deposits are in theory at more risk than money market unit trusts as these reside with banks directly. It is worth pointing out however that South African banks are in general extremely well capitalized, are sound financially and to a large extent have no funding problems. Currently, we have no reason to believe that any of South Africa's large banks are vulnerable to the type of financial balance sheet distress that should worry deposit holders.

5. How long will this crisis last?

The unraveling of the intricate financial instruments created by financial institutions over the past decade is likely to take longer than most people originally expected and the impact has already been worse than most market experts could have imagined. The Wall Street fall-out will also hurt Main Street; previously this was not a certainty. However, things will improve. At present, a war is being waged, central banks and governments account for one army and fearful investors constitute the other. It is the war of liquidity against fear and the good news is that there is currently no immediate shortage to the ammunition stockpiles for central banks and governments. A wall of money is being manufactured and is building and at some point will make its way into the financial system. The latest corporate take-overs in the US's financial sector and Buffet's investment in GE implies that some astute long-term investors perceive the current collapse in share prices as an opportunity and talks to the latent value in many companies. Of course, this is being completely ignored by markets which are dazed by fear.

This is undoubtedly a serious financial crisis by anyone's standards. It is changing the landscape of markets, metamorphosing the entire financial services industry and affecting the wealth of millions. It is also of course not new to markets, great companies will prevail and sound and rational investing will in years forth reap handsome returns.

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