LESSONS FROM THE FINANCIAL CRISIS FOUR YEARS ON

By Edward H. Ladd
Chairman Emeritus
Standish Mellon Asset Management LLC

Investors are (once again) searching for new definitions of the path to investment success.

EXECUTIVE SUMMARY

As the worst of the financial crisis began to subside in 2009, Standish Chairman Emeritus Ted Ladd reported from the front lines on what a number of institutional investors had to say about what had surely been the most stomach-churning months and markets of their financial careers. Four years on, Ted has returned to find out what lessons, if any, have stuck and whether investment behavior has changed. What follows is a summary of comments gathered on faltering faith in conventional investment wisdom; impaired trust in investment management providers; and new views on liquidity, risk management, investment time horizons, asset allocation, return expectations, spending rates, manager scrutiny and governance.

While I have accumulated 52 years of investment management experience (50 of those at Standish alone!) and have witnessed many financial panics, for me the financial crisis of 2008/2009 was the most severe and consequential. As such, I had to believe that institutional investors had derived lasting lessons that continue to influence their behavior. Over the last few months I have interviewed about 40 institutional investors from foundations and endowments as well as from corporate and public pension plans (on the promise of anonymity and confidentiality). While it is difficult to generalize about such a varied group of investors, I did detect some subtle but profound changes in behavior and practice. Hardly surprising, as the crisis was a searing experience and turned a number of our long-held investment convictions on their head. As we move into year four following the crisis, I thought it would be useful to describe the major concerns and lessons that still remain.

1. **Confidence has eroded** that managers and investors understand the keys to successful investing. While many markets have recovered since the crisis, a titanic amount of money was lost, institutions were compromised, models and risk metrics did not work as expected, patterns of long-term returns from different asset classes were disrupted, and the expected benefits of diversification often failed. Investors are (once again) searching for new definitions of the path to investment success. They desperately want better solutions, even if they still may not be willing to really change their behavior.

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2. **Many investors say they have lost trust** in investment management providers because of their misadventures, bad returns, misbehavior and rampant self-interest. There are still concerns about the suboptimal alignment between investment advisors ("who are acting as agents rather than owners") and their clients as well as financial innovations gone wrong and poor advice. The sting is made worse by what is perceived as outsized fees and high compensation for investment providers and by the relatively few miscreants who have been punished (to date). Respondents suggested too many investment managers act as "vendors" rather than "strategic partners." Of course, the increasing specialization of managers and a continued emphasis on style boxes and benchmarks make it difficult to sustain strategic partnerships. The investment management community will need to work hard to regain the trust of institutional investors.

3. **Liquidity remains a pressing issue** because illiquid investors suffered so much damage during the panic. It is obviously harder to maintain liquidity when the cost of holding cash is enormous. There is understandably deep concern, given what has been essentially zero return on high-quality short-term instruments since 2008, as well as Federal Reserve commitments to continue its accommodative policy, probably until 2015. One thoughtful observer noted that while returns on cash are currently nonexistent, it is better to hold cash when risk-free yields are very low than when they are high, which usually means risk assets are more attractively priced.

   One response to the desire for more liquidity might be more holistic planning by investors and tighter integration of investment management with the risk tolerance of the sponsors. Investors are looking at their total balance sheet exposure, potential liabilities, and adverse contingencies. Chief investment officers and chief financial officers of endowments and foundations now have closer links and better communication. Institutional investors are giving special focus to cash flow planning, including future private equity calls and construction programs; the possibility of accessing secondary markets to reduce exposure to private assets; and using proxies (e.g., REITs rather than real estate partnerships).

   I did not find greater interest in meeting liquidity needs from lines of credit. Nor did I detect any enthusiasm for considering a portion of the cost of holding liquidity as analogous to an insurance premium to reduce risk for the sponsoring institution (as opposed to viewing it as a detriment to investment returns). A few of my interviewees mentioned a possible financial transaction tax which, however improbable, would have profound implications in terms of "throwing sand in the gears," and thus raising transaction costs, reducing liquidity, and maybe lengthening time horizons. In any case, the memory of the liquidity squeeze during the credit crunch remains intense so that investors are now struggling to retain liquidity, even in this costly environment. Moreover, due to regulatory changes and reduced risk appetite at dealers, there is less "street" liquidity at a time when investors want more of it.

4. **Looking at risk in new ways** remains, unsurprisingly, a continuing imperative, because so many of the old risk management tools (especially value-at-risk models) failed to protect as planned. There are no obvious "silver bullets" to better define and hedge risk. While there has been greater attention to protecting against tail risk, most of my respondents felt tail risk protection was currently too expensive.

   There was also some disenchantment with long-term Treasuries as the great diversifier during financial panics, because the yields are now prohibitively low. However, there were few nominations for alternative diversifiers in a panic beyond long-term Treasuries. Part of risk control involves scenario planning, trying to define "worst-case" events, greater attention to potential liquidity needs (see #3 above), evaluating counterparty risk, and more rigor in predicting volatility as opposed to extrapolating correlations and returns. Some institutions have defined risk as "the risk of not meeting liabilities" as opposed to declines in the market value of assets.

   One interviewee said that before the crisis, risk was defined in relative terms versus a benchmark; now it is deemed to be absolute risk. There is less appetite for leverage (ironically at a time when the cost of leverage is extremely low). I did not find any institutional investors relying solely on quantitative measures of risk. Instead, they were generally more conservative in their risk appetite and more reliant on qualitative assessments.

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5. **Investing time horizons do not seem to have changed** despite the general belief that excessive extrapolation of recent returns and correlations has been a losing strategy. As one investor stated: "Herd behavior is a proven value destroyer." Many of my respondents decried the short-term orientation of corporate decision-making, financial markets, and investment managers. One investor noted that longer-term investing has been made more difficult by accounting rules that create more pricing volatility and a greater mismatch between financial reporting and underlying asset values. High frequency trading in equity markets remains a prominent issue, with intense concern that it fails to provide either reliable liquidity or efficient markets.

   Some institutions are less enthusiastic about model-driven tactical asset allocation. At the same time, many investors say they wish to be more nimble and opportunistic. An interesting irony is that while some institutions said they have less trust in investment managers, they are willing to give managers more flexibility to be opportunistic and deviate from benchmarks. A few claimed to have become more contrarian and value- oriented, arguing that the adverse market environment now creates more opportunity, as will the next financial crisis. Before my interviews, I had expected that investors who had been punished by momentum investing would be prepared to take a longer and more fundamental view of investment management; but that does not appear to be true. Business risk, career risk, and psychology apparently make it hard to change behavior.

Another common belief was that all developed economies were heading for trouble, with bad demographics in Japan; a flawed currency regime and sovereign debt challenge in Europe; and the inability to achieve rational fiscal discipline (or even discourse) in the United States.

6. **Changes in asset allocation** as a reaction to the financial panic are more muted than I had expected. I did note less appetite for large corporate buyout funds (and a pervasive concern that past positive returns from such funds relied more on leverage than investment acuity). Disappointment was expressed in fund-of-fund hedge funds because of the financial drag from multiple fees.

   I heard concern about economic prospects in Europe but also interest in buying distressed debt from European banks forced to liquidate loans. There was more appetite for emerging market stocks and bonds. This was partly based on the belief that developing economies may have better balance sheets than those of the developed world but also on the notion that home-country bias was eroding. There was also a conviction that enthusiasm for the emerging world would create large potential demand for emerging market securities in relatively small markets.

   At the margin, the quest for liquidity (see #3 above) has resulted in some scaling back in appetite for private equity as well as long call commitments and lock-ups (even though there may now be more access to previously closed private equity pools). A few investors waxed enthusiastic about buying partially mature private equity funds at a discount in secondary markets rather than making commitments in new partnerships. Lastly, there were a number of investors who are thinking less about conventional asset allocation and more about risk buckets (e.g., inflation, deflation, credit, growth, etc.). Many investors expressed concern about potential inflation but indicated they have not yet taken much action. In general, less had changed in asset allocation than I expected, given the carnage during the financial panic.

7. **Lower expected investment returns** were the prediction of most interviewees. Given the fact that we have already witnessed what is sometimes described as a "lost decade" of equity investment returns and that public market equity valuations appear reasonable, I was surprised that my contacts were so negative. Maybe this pessimism is an extrapolation of recent poor returns, despondency about economic fundamentals, or reaction to the fact that returns from very high quality bonds starting from today's low yields will almost assuredly be quite limited.

   Other directional comments were that real interest rates would return to their long-term averages with a resulting headwind for all financial markets; some of the secular forces that have been a tailwind for the U.S. would wane; and corporate profit margins would surely someday revert to the mean. Another common belief was that all developed economies were heading for trouble, with bad demographics in Japan; a flawed currency regime and sovereign debt challenge in Europe; and the inability to achieve rational fiscal discipline (or even discourse) in the United States. Perhaps this pessimism could be a contrarian indicator: one optimistic contrarian asked: "What happens if something goes right?" However, the vast majority of investors I spoke to were downbeat and hunkered down.

8. **If there are lower returns, will there be lower potential alpha?** Far from consensus on this important question, I found rather sharply varying opinions. Some institutions believe the opportunity set will remain high and that investment managers will have plenty of volatility to work with. It was interesting that most investors assumed that despite currently low implied volatility, the magnitude of the risks suggested that future volatility would be high. The continued dispersion of returns from different asset classes as well as reduced market liquidity may create volatility.

   Those who believed alpha would be limited argued that there are fewer unexploited asset classes and that individual securities provided fewer selection opportunities as long as markets were obsessed by "risk on" or "risk off" patterns. This would argue against rigid style boxes. Investors voiced understanding of Federal Reserve policy but also frustration that continuing monetary easing was suppressing volatility and mispricing risk. If there was consensus, it was that *IF* alpha opportunities are more limited, investment management fees are too high. The opinions of institutions about fees, in combination with less trust in investment providers (see # 2), implied that more commodity asset classes with lower potential alpha should be indexed at lower fees, especially since it was difficult to negotiate lower fees for top-performing private equity managers.

9. **Pronounced changes in desired sustainable spending rates** were visible across many different types of institutional investors. In general and despite pressure on operating budgets, endowments are attempting to reduce spending rates and smooth the impact of volatile returns. Many are opting for the Yale endowment model, with the majority of the annual spending calculated from the prior year's return plus inflation. The balance is based on more recent market values, with some discretion for managing the spend within a collar of roughly 4% to 6%.

   I sensed that most endowment funds would like to move toward a 4.5% spending rate rather than the old 5% standard. The predominant argument was that with a fixed annual payout of 5% plus expenses, foundations have a more difficult challenge than endowments since they are not likely to benefit from additional philanthropy and their grants are stickier to needy social services that are especially adversely affected in volatile times. However, some argued that foundation grants are somewhat more flexible than endowment spending for institutions heavily dependent on investment returns to support employment costs. On the other hand, corporate pension funds seem eager (some say "desperate") to get the liabilities off the corporate balance sheet and are trying to match assets and liabilities, even if the investment environment of very low interest rates makes this painful.

   Lastly, almost all agreed that state and local pension funds with roughly 8% assumed returns, large unfunded liabilities, heavy pressures on government budgets, and less nimble investment procedures are facing a particularly onerous and potentially unsolvable problem (to be compounded as federal deficit reduction passes on unfunded mandates to lower levels of government).

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10. **Manager scrutiny is increasing** not only because of disappointments about investment results, but also due to concerns about compliance, transparency, risk, financial stability, and sources of alpha in what is perceived as a low-return environment. One respondent noted that institutional investors were particularly fixated on the question of "How did you do in 2008?" Others focused on the need for private equity managers to have some sort of succession plan for management and ownership. I heard heightened concerns about fees, especially for higher cost asset categories, and frustration that there was not more fee competition in hedge funds and venture capital partnerships. There was also renewed interest in index exposure to what are perceived as commodity asset classes to moderate the overall cost of management. Investors were split on whether they had too many managers (hard to supervise adequately, especially when there is a problem) or too few (the need to have a farm team in case of manager turnover).

11. **Governance of the investment management process** is evolving, with the practices of investment committees under intense review. Many admitted that the financial panic of 2008 revealed an inability to be sufficiently nimble in the face of a crisis. I detected an increasing willingness to delegate more tactical responsibility for the portfolio to permanent management.

    Many cited the Charley Ellis article on investing in the *Financial Analysts Journal* (August 2012) as a critique of how investment managers, investment consultants, investment committees, and even the institutional investors themselves had lost proper focus. There were a few concerns with the consultant model, even amid greater reliance on consultants given the heightened complexity and perceived risk of markets. A lively topic was the optimal size, scale, and resources of the institutional investor. While very large institutions might have problems putting their money to work (especially in competition with huge investment flows from sovereign wealth funds), there was also more acknowledgement of the difficulties of smaller institutions that simply did not have the scale to do the manager oversight, compliance and risk analysis. More of these smaller investors expressed a willingness to outsource the entire investment management function, believing it is not within their competence to do the job internally.

CONCLUSION

While some observers felt that we are so short-term-oriented that any lessons from the financial panic had already been forgotten, others argued that the full implications and lessons have yet to be absorbed, especially as the financial crisis bleeds into global deleveraging and demographic headwinds. However, my overall impression was that the pain of the crisis was so great that, on balance, lessons have indeed been learned and some behavior has changed. Whether those changes will sufficiently equip us to weather the next crisis, is of course the larger question. That, unfortunately, cannot be answered until the next (and probably quite different) crisis is upon us.

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