Managing wealth in financial crisis

Portfolio managers need better education and training as tasks are more demanding now, write FRANCIS KOH and KLAUS SPREMMANN

A VING a diversified investment portfolio has not contained high-net-worth individuals and billionaires from huge losses in the global financial crisis. Even Warren Buffett, the investment wizard, took a big hit. His flagship company Berkshire Hathaway lost half its value between Dec 11, 2007 and Nov 20 this year. Why, because all the different markets will now become highly correlated and exhibit similar co-movements – downwards.

Prior to the crisis, the stock market was liquid, volatile and robust. Many high-net-worth individuals and institutional investors saw it as a safe way to increase their wealth over the long run. Some even borrowed to leverage their positions to capitalise on this historical "whirlwind." Others followed the doctrines of Modern Portfolio Theory (MPT) to diversify their wealth across different asset classes to avoid concentrated bets on a few securities.

MPT was pioneered by Harry Markowitz, William Sharpe and others Nobel Prize winners. It posits the need to focus on the trade-off between risk and return, MPT also teaches that "portfolio risks go beyond 'market risks'." There are significant liquidity risks which have to be managed, and liquidity risks are embedded in the global financial system.

The current crisis may be traced to particular tracts within the financial system. The media first reported signs of distress in 2007. The possibilities of housing losses problems and a sub-prime crisis were mentioned. Those problems lingered.

Increasingly, the whole financial system was severely stressed in the ensuing months. Banks tumbled, housing stock markets crashed sequentially and in sentiments.

The malaise of the financial world exerted its toll on the real economy. No stock market or physical market around the world was spared. Anxieties, manufacturing companies and consumers are witnessing lower demand in one segment, if sufficiently large, liquidity can vanish virtually overnight. Traditionally, liquidity can be provided by other investors in the markets. It is apparent that the current financial crisis, originating from the housing and credit markets in the United States and Europe, has crossed borders to infect all economies.

Why has this happened? Over the years, markets became more inter-connected, and inter-dependent. A global market failure is one in which changes in one geographical market has a knock-on effect on other markets, in other developed and emerging economies.

Among the techniques and instruments which have amplified this inter-relationship are securities, structured products, and credit default swaps. The returns and payments associated with these derivatives depend on the returns and payments of their underlying assets, which may be complex and structured products of some form.

Many financial products are sold provided their underlying worth is holding well. Firms have been structured out of other funds, which were made of derivatives contracts. In the end, nobody could say how far a small disturbance in one product could spread, and how other securities would be affected.

Only a few years ago, several investment markets were fairly independent. For example, real estate, stock, fixed income, commodity and private equity markets primarily follow their own developments. These days, financial innovations are causing these markets. Consequently, many of these asset classes are linked and inter-related. They no longer exhibit independent price movements.

It should be noted that these worldwide connections have many benefits. If an investor wants to attain a particular financial position, there is one more way to construct it. With innovations and financial engineering, there are many ways to create products which meet the needs of investors. Prices are also more competitive. Much more information is available to investors.

Many of these benefits are not possible in the same way to financial engineers to construct across physical product and geographical markets.

Metaphorically speaking, the modern financial system is like a huge circus tent which gives protection from the wind. The tent remains stable even if the wind escalates to a storm. However, if the wind escalates to a storm, and if the storm becomes too strong, all the con- nected pillars would suddenly move in the same direction. For the portfolio investor in this situation, the bad news is that diversification will not work when he needs it most.

The inter-relationship of financial markets is bad news for the diversified portfolio investor. In normal circumstances, the change of the market moves in a direction opposite to the investor’s thesis. However, in the face of the real crisis, there is no such diversification. The returns and payments associated with the diversified portfolio are not less.

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After the current crisis has settled, wealth managers will need to decide on the complement of different asset classes. Credit and financial markets will provide better equipped wealth managers in a globalised world to service the needs of their clients who face a complex world of changing weather conditions.

Clients have diverse needs, risk appetite and returns requirements. Wealth managers are now more than ever before. But the new tasks are more demanding and require better education and training. There is a demand for better-equipped wealth managers in a globalised world of finance. Finance and banking are very necessary in our modern world, but now they require more knowledge and expertise. More education is required, not less.

The current crisis has shaken banks, banking, wealth management and other financial services as an industry will offer more employment positions for young people, not less.