Gain better protection over assets

One principle that stands is the need for quality diversifying of financial investments, says FRANCIS KOH and KLAUS SPREMMANN

The crux of the matter is how one can mitigate or inoculate against a Black Swan event, even as one cannot predict its occurrence ex ante.

The recent banking initiative in the US encourages “investment banks” to become involved in integrated commercial banking to avoid potential failure. This provides evidence that single industry businesses are more vulnerable than multi-industry firms. One clear principle which appears in a new light is the need for quality diversification of financial investments. To allocate resources (and liabilities) over different regions of uncertainty remains an important principle.

In normal circumstances, naïve diversification based on historical correlations may work as long as segments of the financial market – property, fixed-income, credit risk, equity, currencies – revert to their historical properties. But naïve diversification fails when correlated assets move uncorrelated assets move together.

The interconnection of the various segments within the world of finance was enhanced by the use of extreme leverage, short positions and growth of hedge funds, which use global macroeconomic developments as investment opportunities. Hedge funds, for example, exploit market inefficiencies and these strategies exacerbate correlations and amplify market movements.

All these developments may be summarized as follows: the stronger the connections between various parts of the world economy make the global financial system more stable when volatility remains within its usual bounds. However, the global financial system is threatened when volatility increases to extreme magnitudes. Small and more frequent disturbances have minimal impacts in normal cases. But rare and very heavy shocks can cause chaos to segments within both the real and the financial sides of the world economy at the same time.

A statistician would call the 2008 financial crisis a 3-Sigma-Event to indicate that such a huge amplitude of a normally probability economy happens only once in a hundred years. To many, we might have encountered a “Black Swan” event. Everyone may hypothesize that a bubble is building and will burst at some point, but nobody can predict when it will happen, nor would they compute the consequences, or impact of such a situation. When it has happened, as in the current financial crisis, we are aware after the fact and can explain it fairly well.

Crisis emerge in random and unpredictable ways and the scale of these random events may vary.

Yet, the law of probability says that events with higher impacts are rare while smaller disturbances are more frequent. What this means is that management needs to have better capabilities to weather extreme events. Management needs improved risk management perspectives. We suggest three critical imperatives:

- To implement adequate investment diversification and hedging
- To increase organisational liquidity reserves
- Product-market diversification may be useful

The current financial crisis has diminished the assets of many investors, banks and industrial firms around the world. The assets of typical investment funds would have lost almost half of their market value, and the creditors’ worth of most firms have declined to abysmal levels. In the Singapore context, firms have been shifting up their equity bases to strengthen themselves pre-emptively.

Yet, commercial banks are generally not loosening credit. Liquidity, although urgently needed, has become scarce. Financial losses and the lack of liquidity have been aggravated by the deterioration of real demand in the economy. Consumers have lost confidence. Purchasing firms have over-stocked with inventory. Airlines, having lost passenger and cargo traffic, have been affected by innovative financial products, equity, currencies. Equities have lost value. While investment diversification may not develop new developments as investment opportunities. The interconnection of the various segments of the world economy makes the global financial system more stable when volatility remains within its usual bounds. However, the global financial system is threatened when volatility increases to extreme magnitudes. Small and more frequent disturbances have minimal impacts in normal cases. But rare and very heavy shocks can cause chaos to segments within both the real and the financial sides of the world economy at the same time.

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