

Keeping your head above water in tough times by Paul Clitheroe

Like you, I was not pleased when I read some of the news headlines over the last week or so around the crisis in the US financial system. No one likes to see investment markets fall so sharply. I thought you would be interested in an update about the current turmoil, how you might be affected and what we can learn from history.

Despite the current volatility my advice has not changed. I urge you to stay focused on the long-term and be patient, this sensible strategy will see you well-placed when markets eventually recover.

What has happened?

Lehman Brothers Holdings

Lehman Brothers, the fourth-largest U.S. investment bank, succumbed to the sub-prime mortgage crisis on 15 September with the biggest bankruptcy filing in history. After huge losses in the US mortgage market and they were unable to find a buyer.

Merrill Lynch

Merrill Lynch, the largest share broking firm in the US, has been taken over by Bank of America for \$US29 per share – its share price was \$US100 in early 2007. A key driver was Merrill Lynch's bond trading operation that invested heavily in high-risk / high-return securities backed by sub-prime mortgages.

American Insurance Group (AIG)

AIG is the largest insurance company in the world and was rescued by the US Federal Reserve – to the tune of \$US85 billion to prevent it from collapsing. AIG's losses were linked to exposures to the troubled US home loan market.

Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are two investment entities, originally established by the US congress to underwrite mortgages to support the housing market. The deteriorating US housing market has seen them write down losses of \$US14 billion. Fannie Mae and Freddie Mac is now under US government control as a temporary measure to help stabilise the mortgage market.

How have markets and governments responded?

- 👉 Fortunately governments around the world have responded to the crisis, taking significant steps to secure the financial system so that current imbalances can be dealt with. The Bush administration proposes to establish a fund that would buy up to \$700 billion of distressed mortgage investments.
- 👉 A consortium of 10 global commercial and investment banks – including Barclays, Citigroup, Goldman Sachs and Deutsche Bank – have formed a lending facility set at \$US70 billion that will provide additional liquidity to the market.
- 👉 The US Federal Reserve has interest rates in its armoury and can move interest rates lower to provide more stimulus if required.
- 👉 The European Central Bank, the Bank of England and the Swiss National Bank have indicated they are ready to provide added liquidity if needed and the former two followed up by injecting more money into money markets.

How does this impact investments?

- 👉 Pressure on the financial system has seen investment markets extremely volatile, with this turmoil is likely to continue over the short-term. Over the last year, shares, corporate bonds and listed property have been very volatile and have posted negative returns. Government bonds have performed well as investors have looked for safety.
- 👉 Even fully diversified portfolios will not be immune to the turmoil and small losses, which will not be recovered, are likely to have occurred. However for truly well diversified portfolios the holdings in specific stocks is extremely small. In August, the Pathways 70 portfolio has just a 0.08% exposure to the company. While exposure to AIG in the Pathways 70 portfolio is 0.20% and Merrill Lynch 0.06%.

Is there any positive news?

Yes. There are a number of factors that provide you with reason to be optimistic about the outlook for investment markets and the global economy:

- 👉 The Australian banking sector is less exposed to poor mortgage loans or 'low-doc' mortgages.
- 👉 Lower world oil prices will help consumers resume spending, which provides additional support to the domestic economy.
- 👉 Lower mortgage rates and lower housing prices are helping home affordability in the US, which in turn supports the US economy.
- 👉 Central Banks around the world will act to lower interest rates and enhance liquidity to combat slowing economic growth if required.

What has history taught us?

- 📌 Over the last Century, the share market (as measured by the US Dow Jones Industrial average) has produced far more positive returns more often than not. It has fallen by more than 20 per cent in a calendar year on five occasions but has risen more than 20 per cent in a calendar year 23 times. This demonstrates that over the long term, the good times far outweigh the bad – it just doesn't feel like that in the midst of a storm.
- 📌 The failure of well-known financial institutions also occurred during the last cycle in 1990, when Drexel Burnham, then the fifth largest investment bank failed. As did many relatively large banks in Texas and New England. The banking industry emerged after that down cycle far stronger and more profitable than any time before. Source: Alliance Bernstein.

Checklist for success in tough times

Work through this checklist to check if you are positioning to ride out the current market turbulence.

- ✓ I understand that history has demonstrated time and again, that investment markets not only recover from these bouts of turmoil, they invariably go on to rise again and go past their previous highs.
- ✓ I understand that emotions can take over during volatile times, but I am going to ignore all the 'noise' and continue to make rational (not emotional) decisions. This will help me stay focused on the long-term so I can reap the benefits when markets do eventually recover.
- ✓ I know that I have a team of experienced investment professionals managing my portfolio to ensure it is well-diversified across asset classes, managers and investment styles. I also understand my portfolio is monitored very closely and is well placed to enable me to participate in any upside when markets bounce back.
- ✓ I feel confident that I can call my financial adviser if I have any questions relating to my investments or if I am planning to make any changes to my portfolio.