

The Global Search for **Safe Investments**

In this paper, we will attempt to provide a short summary of the chain of events that contributed to the financial turmoil of the years 2007–2009 in order to find out which drivers are still in play, what has changed as a result, and what this all might portend for the next few years.

“I am the wisest of the wise because I know that I know nothing.”

Socrates

These words by Socrates capture the emotional, if not the rational, truth still felt by a majority of investors that have survived the financial crisis so far. While many investors did see one or two of the warning signs—overvalued property markets; imbalances in national economies; the low savings rate of Americans; rapidly expanding money supply; abnormally low interest rates and spreads; and the significantly high proportion of bank profits compared to total corporate profits—few, were able to convert these pieces of evidence into an investment portfolio that enabled them to navigate the global crash that ensued. Many investors lost their bearings, as many models and investment paradigms failed when the underlying conditions that validated their results vanished.

In reality, global markets and economies have become so enmeshed, intricate, and unpredictable that investors can no longer blindly rely on investment modeling/paradigms (quantitative, econometric, credit, allocation, etc.) to guide their course of action. The numerous factors determining the return of an asset class have reached a degree of complexity that should give any individual attempting to forecast or time an investment pause—and, hopefully, a dose of humility. At such, we believe it is critical to fundamentally examine the underlying potential drivers of returns, if only to determine the validity of any investment course to be guided by a given model or paradigm.

The Road Toward the Crisis¹

The drama began to unfold in the 1980s and 1990s with the desire of the U.S. government to give the bulk of the U.S. population a chance to acquire reasonably priced homes. The stated goal was to build an “ownership society” by making the purchase of real estate as inexpensive and simple as possible. To that end, quasi-governmental institutions such as Fannie Mae, Ginnie Mae, and Freddie Mac were brought to bear, private mortgage banks and the entire real estate market were supported, the deductibility of mortgage interest was made easier, and, in many areas, residential property was subsidized.

Sensing a huge business opportunity, the banks were only too happy to oblige. As the financial innovation of “securitization” had been available since the 1970s, thanks to Ginnie Mae, banks gladly loosened their purse strings to grant loans; in so doing, they expanded their clientele and continuously increased their sales volumes. Eventually they were able to sell mortgages on the market without having to carry any of the long-term risk. The deregulations of the 1980s and the removal of the separation between investment banks and depository banks in the United States (through the repeal of the Glass-Steagall Act in November

1999) facilitated these transactions and contributed to a massive expansion of the market, in the process exporting the risks of the U.S. real estate market worldwide.

Eventually the enormous success of the market led to both a loosening of credit standards and an increase in complexity. Given the eventual inequities of resources caused by the success of the private sector lenders, neither U.S. government regulators nor the ratings agencies, responsible for evaluating and supervising the issuance of new securities on behalf of the market, were actually in a position to exert any real control. If, as appeared to be the case, the resources of the private industry attracted the best graduates at the top universities through their incentive systems (compensation, reputation, and freedom), it is not difficult to predict the outcome of any contest between these parties in a deregulated market. Not only did the banks come out ahead, overwhelmed regulators and rating agencies also became prone to conflicts of interest rising from their own incentive systems.²

Over the years, the securitization process led to the creation of ever more new credit (and an expanding universe of securitizable, illiquid cash flows), as well as, parallel to the regulated banking system, a shadow banking system made up of special-purpose vehicles (financial enterprises in the field of securitization) that worked like banks but, critically, were not subject to government supervision.³ This shadow banking system allowed the real banks to circumvent regulatory hurdles, so as to facilitate the expansion of profits without having to come up with any new permanent risk capital. It would later contribute substantially to the crash as many of these vehicles refinanced themselves in the money market for the purpose of taking long-term risks—which made the road from illiquidity to insolvency, in times of falling asset prices, a very short one indeed.

This is where globalization comes into play. Its triumphant advance in the last few decades triggered an enormous increase in wealth in the world—which was distributed very unevenly, both regionally and among people. This explosion of assets in the countries that benefited from globalization, as well as in the hands of the rich and superrich, led over the years to a shortage of investment opportunities, as all this new wealth went in search of safe—and yet productive—investments (the so-called “savings glut”).⁴

An example is provided by the Landesbanken, a group of state-owned banks in Germany. Before the expiration of a public guarantee in July 2005, this group had raised enormous amounts of money in the markets without having to show matching transactions on the assets side; this ultimately plunged it into an extraordinary asset crisis. With its now-toxic holdings in U.S. assets, the Landesbanken made a not negligible contribution in this crisis by spreading the “financing pandemic” into Germany.⁵

These processes were fueled by an over-expansive monetary policy that had been in effect at least since the rescue of the hedge

fund Long-Term Capital Management in 1998, when central banks learned that they could solve globalization-triggered crises by using an aggressive, expansive monetary policy. That experience has shaped monetary policy to this day, with the result that the world has been inundated with liquidity for more than a decade. The persistently low interest rates triggered by all this only added fuel to the above-mentioned fire of real estate financing by banks and the growth of the unregulated shadow banking system associated with them.

The Great Moderation

The Great Moderation was an era characterized by increasing returns, declining volatility, and relatively low levels of business and consumer impairment. Beginning in 1980, inflation collapsed and interest rates declined for over 20 years. During this period, the cost of servicing debt continuously decreased, while the availability of credit was increasingly plentiful. Solvency and bankruptcy—two metrics that are normally correlated to each other—were often uncorrelated during this period due to the low cost and availability of credit. As a result of these underlying conditions, yield and rating became extremely predictive of investment outcome and investors responded logically to this new found low impairment environment.

Private sector debt increased to unprecedented levels during The Great Moderation, as wealth became synonymous with leverage, which is illustrated in Exhibit 1. Unsurprisingly, an excessive amount of leverage magnifies all outcomes—both good and bad. The Great Moderation ended abruptly with the credit/liquidity crisis of 2008 and, so too, did the false predictive power of yield and rating.

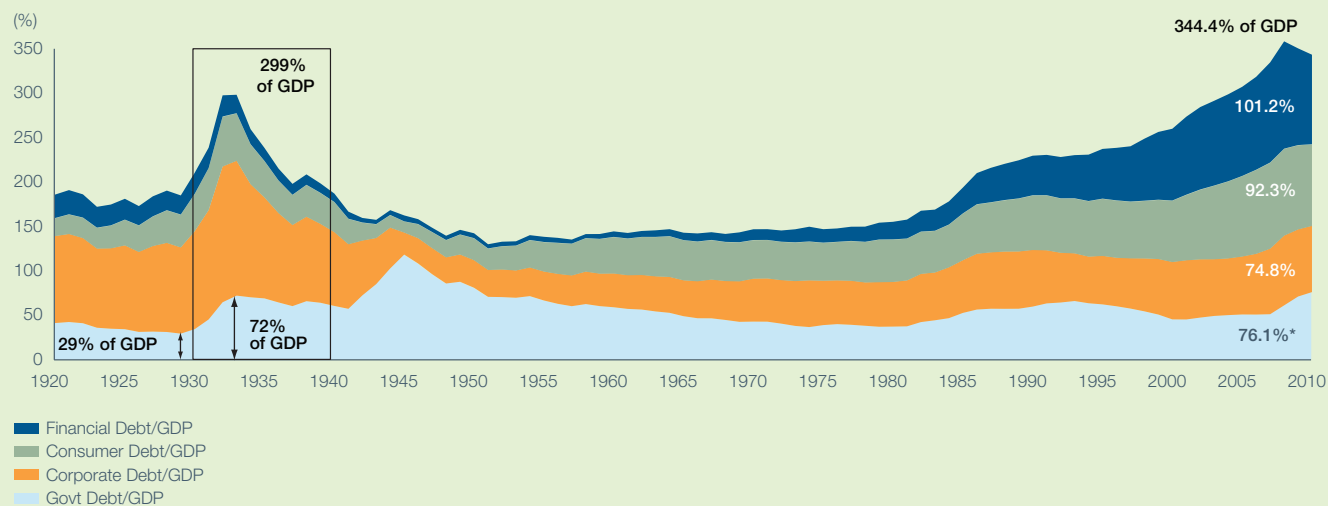
The current environment of deleveraging has been characterized by cash flow disruptions, defaults, restructurings, and government intervention. Much of the private debt has shifted to the public sector, leading to ever-higher levels of sovereign risk. We believe we will continue to experience the consequences created by The Great Moderation until the private and public sectors deleverage to more sustainable levels.

Historically, the *raison d'être* of banks in a robust economy is to translate the available liquidity into lines of credit, new businesses, and growth in the real economy. Yet one constant in all these distortions has been a misdirected incentive system.⁶ The situation in the banks mirrors the changes seen in the last few decades in society at large—namely, the increasing importance of money to individuals. The economic and social controls have shifted more and more toward monetary incentives and individualism.

In the banking sector this has been evident in the growing spread of the Anglo-Saxon-style compensation system. While performance-related bonuses and profit-sharing do increase personal commitment, they can also lead to excessive risk-taking if there are no sanctions for the negative consequences of risks taken, or if there is no clear attribution of responsibilities because of a lack of transparency—creating moral hazard and principal-agent problems.

Those incentive systems that enticed many to take irresponsible risks and led to short-term decision-making undoubtedly contributed to the crisis. Yet they were only a small piece of the puzzle, and not the cause of this complex process of misguided policies, which can be attributed to a mix of governmental and market failures.

Exhibit 1
The Great Moderation Created Excessive Leverage



As of 30 June 2010

* Government debt above excludes \$4.6 trillion of federal debt owned by other government entities. The largest amount excluded is that owned by the Social Security Trust Fund totaling \$2.6 trillion. Including the debt owned by other government entities, government debt/GDP was 106.9% at 30 June 2010.

Source: U.S. Federal Reserve, U.S. Bureau of Economic Analysis, Morgan Stanley, Bloomberg, U.S. Treasury Department, Social Security Administration

The Role of Safe Investments

There is no doubt that the Anglo-Saxon real estate market was at the center of the gradually expanding crisis, and that the collapse of housing prices in the United States and United Kingdom was the direct cause of the world-wide capital market crash that laid waste to the world economy in 2008.

But one could also point out that the relative importance of these real estate markets was itself the consequence of a deeper, historically unique situation—the global scarcity of safe financial assets.⁷ In fact, we see this as the crux of the problem facing the world economy, and we expect it to continue into the future.

As mentioned above, the globalization of the last few decades was accompanied by increasing wealth, a certain degree of over-saving, and a permanently over-expanding money supply—all of which lead to a demand for safe investments. Unfortunately, safe assets have always been scarce, and have hardly become more abundant over the last few decades.⁸ The exploding demand for such assets—particularly from emerging markets—and their structural scarcity have led to a huge bubble in the markets for safe investments, which has contributed, for example, to the extremely low interest rates of the last decade.

This argument can also be turned on its head. The excess demand for safe investments induced the banks to artificially create assets, such as assets-backed securities (ABS) and mortgage-backed securities (MBS), that were supposedly safe. Using financial wizardry and, ever more, derivatives and leverage, the banks were able to turn uncertain and highly risky assets (with the emphasis on real estate loans) into supposedly high-yielding “safe haven” investments with AAA ratings, via bundling and capital market securitizations, even if everything ultimately turned out to be an illusion. Yet apparently, nary a player among the banks, regulators, ratings agencies, asset managers or investors had a full understanding of the implicit risks of these financial “innovations.”

Thus, the demand overhang in the market for safe assets produced an effect that fed directly into the real economy and contributed in many ways to the emergence of the crisis. In particular, the extremely low interest rate level and the historically narrow credit spreads deceived the issuers (not to mention, investors) about the actual risks of their business, and led to excesses in many areas.

Ultimately, we believe this lies at the core of the problem that led to the excessive leverage seen across the world over the last few years: the market simply did not send out the correct signals. The debt-financed over-consumption of Americans, the new-economy boom of the 1990s, and the (also debt-financed) permanently expanding welfare state of many OECD countries can also be blamed on the fact that interest rates have been much too low for most borrowers, issuers of bonds, and governments for years. In our view, many an interest rate would be much higher if the market were to price the risk of loans and investments fundamentally.

What Does This Portend for the Future?

It would be difficult to argue that the problem of the imbalances in the market for safe assets has been resolved through the financial market crisis. In fact, we believe the contrary to be true: that the problem has become larger and might therefore threaten capital markets and national economies again in the future. Indeed, in the aftermath of the financial crisis, the demand for safe assets has continued to rise, even as the offer of safe investments has continued to shrink. In our view, the market has therefore become even more unbalanced than it was pre-crisis.

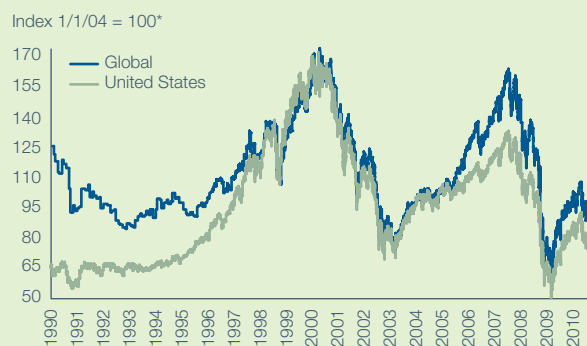
If we have learned anything from the capital market crises of the last few decades, which have become more frequent, it is that, while there is no income without risk, there is such a thing as risk without income. It has also become evident that the risk management of most institutions in these decades of uncertainty was wanting.⁹ Two stock market crashes in one decade, several collapses of property markets that brought the world to the brink of deflation, collapsing hedge funds and private equity firms, ever-more-volatile commodity markets, monetary crises and bank runs—not really an environment to inspire courage in the risk-averse investor.

Exhibits 2 and 3 show that, over the last twenty years, contrary to capital market theory, taking risks has not been rewarded, and that risk-averse investors have a lot of arguments in their favor.¹⁰

The globalization process barely missed a beat during the financial market crisis, and it is running again at full tilt. Yet, investors’ appetite for risk, on a global level, may remain rather limited over the next few years, as, in our view, they will continue to look for safe havens.

At the same time, worldwide financial assets will most likely continue to grow. In fact, the accumulation of assets has accelerated

Exhibit 2
Equity versus Government Bond Returns



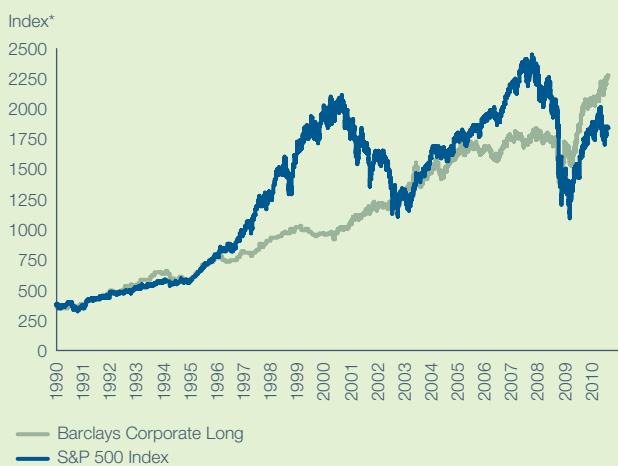
As of August 2010

* Equity/bond total return

Past performance is not a reliable indicator of future results.

Source: Morgan Stanley

Exhibit 3
U.S. Equity versus U.S. Corporate Bond Returns



As of August 2010

* Total return

It is not possible to invest in an index. Indices are unmanaged and have no fees. Past performance is not a reliable indicator of future results.

Source: Morgan Stanley

because emerging markets are accumulating reserves even faster than in the past. And this amassed wealth made it through the crisis largely unscathed due to the rescue operations mounted by the governments; it is already on the rise again (see Exhibit 4).¹¹

If the demand for safe assets does not diminish, what does it look like on the supply side? Could the market be expanded in that area?

The opposite seems to be true. The failure of the securitization markets showed that a large part of supposedly safe assets was an illusion. Not only did the securitization market come to a near standstill over the last few years, no one today would dare say that ABS/MBS investments as a whole are safe. For most investors this asset class disappeared from the face of the Earth, at least in the sense of being a safe investment, as the majority of investors that favored this asset class lacked the expertise to independently analyze the risk.

Worse, doubts about the safety of other asset classes are eating away at many investors, in particular in Europe. After the ABS debacle, the Lehman collapse, and the imploding money markets during the financial market crisis, even investments in money markets have not been considered safe for some time now. So if the banks do not trust each other, why should investors trust them?

What about government bonds? The exploding indebtedness of the last few decades and the additional debt incurred as a result of the bank rescue programs have raised doubts as to whether these debt levels are sustainable for the long run. The European Monetary Union (EMU) crisis involving Greece, Ireland, Spain, and Portugal showed that even securities issued in the EMU area are not necessarily safe any longer. The discussions about the AAA

rating of the main issuing countries—the United States, Japan, and Great Britain—show just how far these sovereign doubts have spread since. After the traumas of the last few years, many investors now live in a world in which they believe that practically nothing is safe anymore and that any scenario is possible. Terms like “default,” “sovereign bankruptcy,” and “currency reform” are used with a levity that belies the seriousness of such concepts.¹²

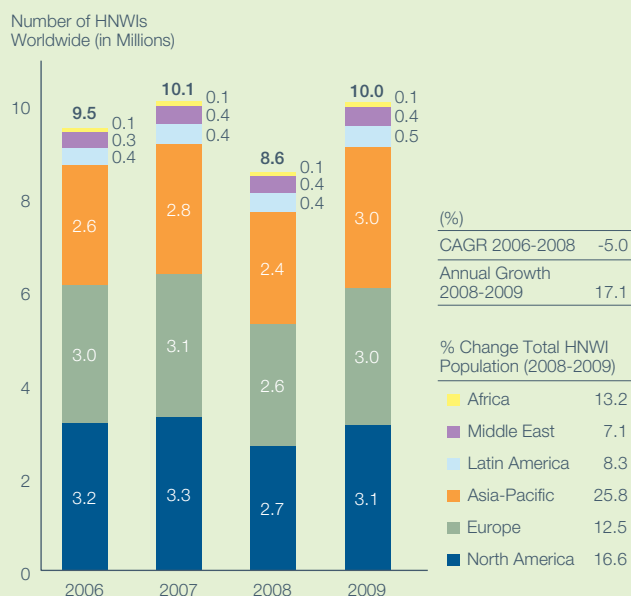
What does this all mean for the markets going forward? Truly safe assets are becoming ever more difficult to identify, while the demand for them continues to grow—exactly the environment that may give birth to a bubble. Particularly, if the presumption of safety is derived from market price behavior, as has been the case in past bubbles. This is probably the only explanation for the fact that the returns on government bonds of the last “safe havens” (countries such as Germany, Switzerland, Norway or Sweden) are inexorably trending downward. This forebodes difficult times in a world in which ever more investors search for the ultimate safety (see Exhibit 5).

The Newfound Importance of Government Policy in Investment Decisions

In a world scarce of safe assets, one has to be ever vigilant of the market consequences of government policy.

For example, in the United States the consequence of the unprecedented magnitude of investment-grade impairment has been massive government intervention. Through initiatives such as quantitative easing, the U.S. government has attempted to re-create

Exhibit 4
Number of High Net Worth Individuals (HNWI) Worldwide



As of 31 December 2009

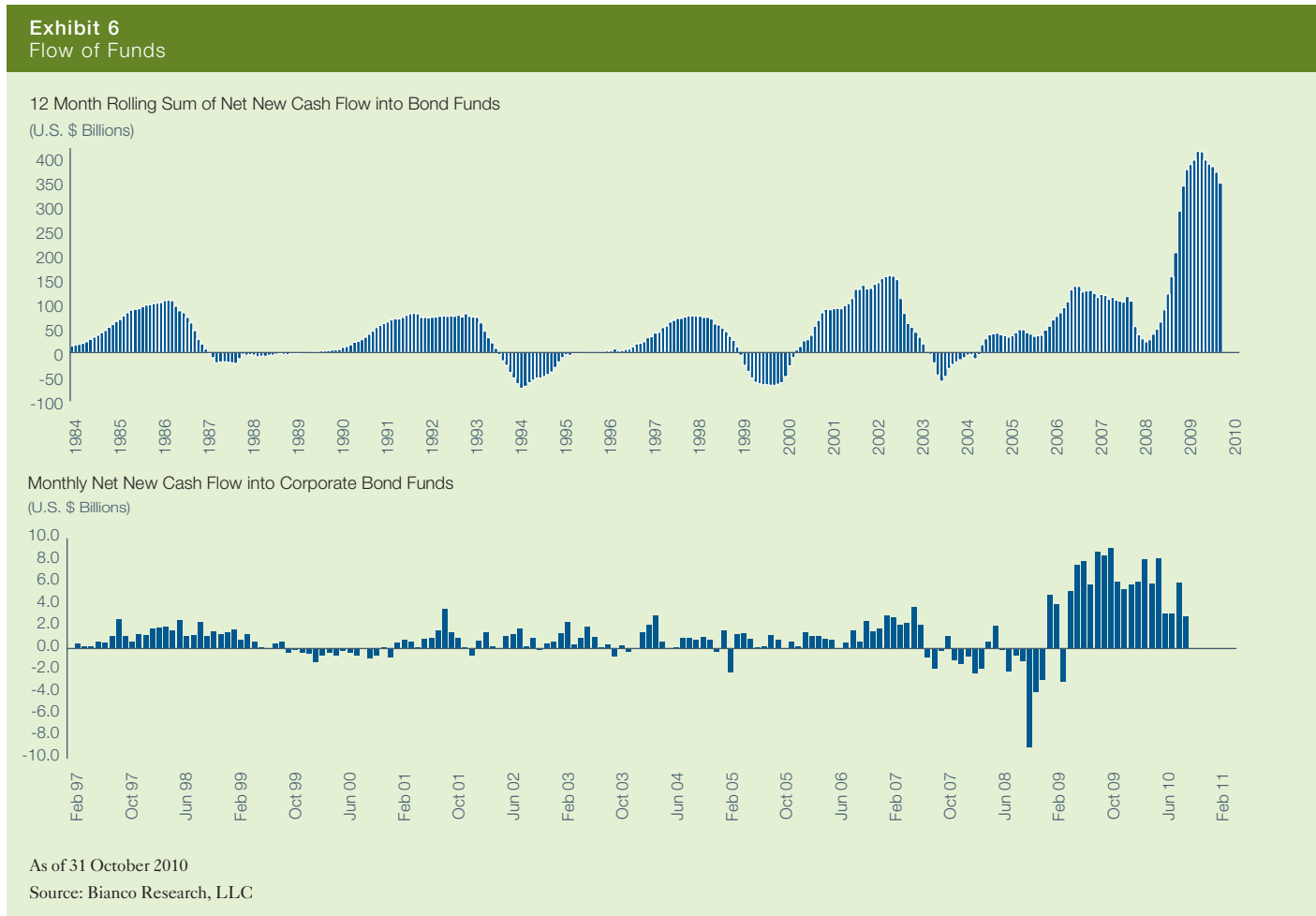
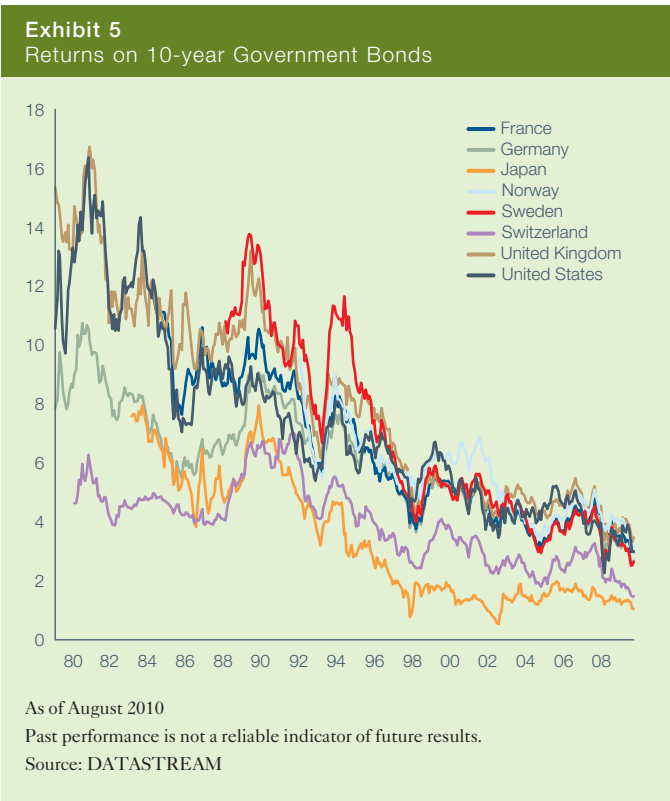
Note: Chart numbers may not add up due to rounding

Source: Capgemini Lorenz curve analysis

the favorable credit conditions of The Great Moderation through direct lending and investment programs, often to the same consumers and institutions that failed during the crisis. The goal is to soften the blow of the investment impairment by extending the resolution time to “cure” it. Whether these initiatives will work or not remains to be seen; however, what is certain is that government intervention of this magnitude can lead to valuation distortions that we believe investors need to consider.

The nature of the government’s intervention has reduced fixed-income liquidity concerns, leading to record flows toward fixed-income assets that are perceived to be safe bets, as illustrated in Exhibit 6. The U.S. investment-grade bond market—intermediate-term corporates in particular—has been a major beneficiary of unprecedented investor flows. These conditions have led to an unusually low yield environment at a time of great uncertainty, and many investors seem unconcerned with this paradox or the risk that the market could shift away from these fixed-income assets when risk appetites change. Much of these flows are, again, the result of the search for yield based on ratings, in our view, leading to the question: Is this investment behavior rational?

It may be rational to the extent investors are truly considering the magnitude and timing of government subsidies in their investment



decision. However, the condition of low interest rates and narrow credit spreads may once again entice investors that are naïve about the underlying fundamentals to take excess risk based on a false sense of safety. Such investors may believe that the paradigm of yield/rating investing is once again predictive of long-term outcomes without considering that the underlying conditions may be the byproduct of government intervention.

Regardless of what investors experienced during The Great Moderation, yield does not equal return, and rating does not equal credit quality. Yield equals risk. Yield is a valuation metric used to compare securities that have different cash flows. It is the discount factor that is used to come at the price that fairly compensates an investor for the risk of lending. The yield utilized to value a cash flow reflects the uncertainty of the cash flow, including the terms and conditions of the cash flow, the operational collection risks, the credit quality of involved parties, and the market for disposing of the cash flow to another investor prior to its termination. The higher the uncertainty, the higher the yield. A rating is a sophisticated credit score derived through financial modeling. The validity of the credit score is dependent on the assumptions, methodology, and the transition data available to the model. Even the most robust credit model can fail over time, as no model can fully capture the nuances present in reality. Absent further analysis and context, yields and ratings shed no light on outcomes.

Summary

The process that led to the financial market crisis of 2007–2009 was a complex interaction of government failure and market failure, where neither the public nor private sector worked efficiently in the context of capital markets or decision theory.

Since the crisis, analysts have, with the certainty of hindsight, pointed to the “boom and bust” in the Anglo-Saxon real estate markets as being the trigger. Yet, while real estate market gyrations unquestionably played a strong role in what has gone wrong in the last few decades, we believe they do not tell the whole story.

We have moved another aspect to center stage in this paper—the imbalances in the market for investments perceived to be safe. While assets looking for these investments have grown substantially worldwide in the course of globalization, the safe assets on offer are of course finite—because safety, unlike assets, cannot be increased at will. This has resulted in a systemic demand overhang for safe investments, causing a sustained overvaluation of safe assets in any risk consideration.

This overvaluation has translated to the low interest rates of government bonds, credit spreads that are much too low, and the artificial creation of supposedly safe assets by the banks through leverage and derivatives (ABS/MBS). Macroeconomically speaking, the permanently low interest rates eventually led to over-consumption, over-investing, over-indebtedness and exaggerated leverage, and ultimately enabled the financial market crisis.

This means that the environment for the world economy and the capital markets could continue to be threatened by turbulence, resulting very likely in ongoing high volatility over the next few years—which will in turn open the door for active asset management that is selective.

We believe that, after the many crises of the last few decades, investors’ risk aversion will remain relatively high. In view of the rising wealth worldwide, it is very likely that the demand for safe investments will keep rising as well. On the other hand, the offer of safe investments will probably decline because hardly anything still looks safe. This might be good news for the few remaining “safe havens” like the government bonds of some core countries of the world (Norway, Germany, and Switzerland), but how will investors react when, some time in the future, even the last safe investments will turn out to harbor risks?

Great opportunity, in our experience, is found during times of great uncertainty. Currently, we believe investors that are selective, tactical, and focused on total returns can find opportunities in: U.S. Treasuries, based on government policy and technicals; Agency mortgage-backed securities, based on loan analysis and a broken prepayment framework; lower-rated corporate bonds, based on fundamental credit analysis; municipals and/or Build America Bonds, based on structural analysis; emerging market local currency debt from countries with currently healthy balance sheets and that are suppliers of raw industrial goods and sophisticated services; and in convertibles, based on volatility and underlying divergences. However, each opportunity needs to be analyzed to ensure that it fits the investment objective, and should be considered within the context of the current investment environment.

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Notes

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- 11 Capgemini/Merrill Lynch, ibid.
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Important Information

Published on 14 December 2010.

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