Financial conditions, alternative asset management and political risks: trying to make sense of our times

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Developments in the financial sector have led to an expansion in its ability to spread risks. The increase in the risk bearing capacity of economies, as well as in actual risk taking, has led to a range of financial transactions that hitherto were not possible, and has created much greater access to finance for firms and households. On net, this has made the world much better off. Concurrently, however, we have also seen the emergence of a whole range of intermediaries, such as hedge funds, whose incentive structures can lead them to take more risk, especially in times of plentiful liquidity and stability. As a result, under some conditions, economies may be more exposed to financial-sector-induced turmoil than in the past. I highlight concerns about the political spillovers if such instability arises.

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Stock markets have been scaling new heights recently. Risk premia and measures of risk aversion are at extremely low levels. With the equity markets anticipating strong earnings growth, credit markets foreseeing low defaults, and the bond markets expecting little inflation, one has to ask: isn't anyone pricing in risks? If not, what is going on?

In what follows, I will argue that we might be seeing the confluence of two strong forces –first, a widespread surge in productivity across the world, with the associated domestic demand varying country by country based on the strength of domestic financial markets, and second, the increasing institutionalization of, and competition within, advanced financial markets for savings. While the world has grown strongly as a result of both these forces in recent years, risks have built up and there is no guarantee that the future will be as rosy as the recent past. Some of the risks are cross-border, and financial –central to the theme of this conference– but I will focus, not just on the risks to financial stability, which have been widely discussed, but the associated political risks.[1]

1| The productivity revolution

We are now in the fourth year of strong world growth, growth that has been maintained in the face of headwinds such as soaring commodities prices. In my view, productivity growth, fostered in part by the revolution in information technology, but also in part by the rationalization of production through the creation of global supply chains, has played a critical role in this expansion. While much attention has been focused on the extraordinary surge in US productivity since 1995, equally impressive productivity growth in emerging markets has been little commented upon. Taken together, rapid, and largely unexpected, worldwide productivity growth can explain why the demand for commodities is so strong, how emerging markets have weathered commodity price increases without a serious slowdown in investment, why inflation is still largely contained despite the unprecedented rise in raw material costs, and why both household incomes and corporate profits are buoyant at the same time.

The reaction of domestic demand to rising productivity growth has varied across countries, in part based on the sophistication of their financial sector. In the United States, for example, the surge in productivity led to a boom in investment in the late 1990s, financed by deep financial markets. Not all the investment was wise, but the debris created by the bust was quickly cleared by the financial markets. Growth picked up again, though corporate investment remained subdued. In addition, though, the United States' strong arm's length financial system allowed consumers to borrow against future incomes and consume immediately. Indeed, the expectation of higher future incomes coupled with accommodative monetary policy and low interest rates may have fueled the housing boom, which expanded consumption even more as the financial system allowed borrowing through vehicles such as home equity loans. Also, residential investment compensated somewhat for the fall off in corporate investment. Thus the United States' financial system translated productivity growth into strong domestic demand, and a large current account deficit (also see WEO September 2006).

Emerging markets countries with less sophisticated financial systems did not have the capacity to reallocate resources effectively to the newly productive areas. Some, for example in East Asia in the mid 1990s, allocated resources indiscriminately, leading to investment booms and very severe busts. Experience brought more circumspection in investment. Others, realizing their limitations, were more circumspect from the outset. Regardless of the path, barring some notable exceptions like China, investment in emerging markets has been relatively muted in recent years (see WEO 2005) even in the face of strong growth. Moreover, because of the limited availability of housing– and retail finance, households in these countries have not been able to expand consumption through borrowing. Thus domestic demand in these countries has been relatively muted and these countries have generated net savings or current account surpluses.

1 *See, for example Borio (C.) (2006):* "Monetary and prudential policies at a crossroads: new challenges for a new century"*, BIS working paper, White (W.) (2006):* "Is price stability enough?"*, BIS working paper, Rajan (R.) (2006)* "Has financial development made the world riskier?"*, NBER Working Paper.*

2| The savings investment imbalance

Despite widespread strong productivity growth, nominal investment, especially corporate investment, has remained relatively weak for the world as a whole, while desired savings is strong. Call this a "savings glut" as did Chairman Bernanke or "investment restraint" as did the IMF, the net effect is an imbalance between desired savings and realized investment. Consequently, real long term interest rates have been low for some time. Interestingly, even as the Federal Reserve raised policy rates during 2006, long term interest rates fell further – in slowing domestic demand in the United States, markets may believe the Fed is aggravating the worldwide excess of desired savings over realized investment further.

Current conditions are unlikely to be permanent. Given aging populations in developed countries though, one would presume that the rebalancing of worldwide investment to desired savings will have to take place primarily in non-industrial countries. Investment will increase partly through foreign direct investment, but partly mediated by the financial systems in emerging markets, which will have to develop further. Increases in consumption as safety nets improve, and retail finance becomes widely available will also help reduce desired savings. Certainly, the seemingly perverse pattern of net capital flows, from poor to rich countries, will have to change, if for no other reason than to accommodate demographics.

I now want to turn to my second issue –the increasing institutionalization of, and competition within, advanced financial markets. The link between the issues will soon be clear. The break-up of oligopolistic banking systems and the rise of financial markets has expanded individual financial investment choices tremendously. While individuals don't deposit a significant portion of their savings directly in banks anymore, they don't invest directly in the market either. They invest indirectly via mutual funds, insurance companies, pension funds, venture capital funds, hedge funds, and other forms of private equity. The managers of these financial institutions, whom I shall call "investment managers", have largely displaced banks and "reintermediated" themselves between individuals and markets.

As competition between these various institutional forms for the public's investment dollar increases, each one attempts to assure the public that they will offer superior performance. But what does superior performance mean?

3| Performance management

The typical manager of financial assets generates returns based on the systematic risk he takes – the so called beta risk– and the value his abilities contribute to the investment process –his so called alpha. Shareholders in any asset management firm are unlikely to pay the manager much for returns from beta risk –for example, if the shareholder wants exposure to large traded US stocks, she can get the returns associated with that risk simply by investing in the Vanguard S&P 500 index fund, for which she pays a fraction of a percent in fees. What the shareholder will really pay for is if the manager beats the S&P 500 index regularly, that is, generates excess returns while not taking more risk. Indeed, hedge fund managers often claim to produce returns that are uncorrelated with the traditional market (the so-called market neutral strategies) so that all the returns they generate are excess returns or alpha, which deserve to be well compensated.

In reality, there are only a few sources of alpha for investment managers. One comes from having truly special abilities in identifying undervalued financial assets –Warren Buffet, the US billionaire investor, certainly has these, but study after academic study shows that very few investment managers do, and certainly not in a way that can be predicted before the fact by ordinary investors.

A second source of alpha is from what one might call activism. This means using financial resources to create, or obtain control over, real assets and to use that control to change the payout obtained on the financial investment. A venture capitalist who transforms an inventor, a garage, and an idea into a full fledged profitable and professionally managed corporation is creating alpha. A private equity fund that undertakes a hostile corporate takeover, cuts inefficiency, and improves profits is also creating alpha. So is a vulture investor who buys up defaulted emerging market debt and presses authorities through various legal devices to press the country to pay more.

A third source of alpha is financial entrepreneurship or engineering – investing in exotic financial securities that are not easily available to the ordinary investor, or creating securities or cash flow streams that appeal to particular investors or tastes. Of course, if enough of these securities or streams are created, they cease to have scarcity or diversification value, and are valued like everything else. Thus this source of alpha depends on the manager constantly innovating and staying ahead of the competition.

Finally, alpha can also stem from liquidity provision. For instance, investment managers, having relatively easy access to finance, can hold illiquid or arbitrage positions to maturity: if a closed end fund is trading at a significant premium to the underlying market, the manager can short the fund, buy the underlying market, and hold the position till the premium eventually dissipates. What is important here is that the investment managers have the liquidity to hold till the arbitrage closes.

4| Illiquidity seeking

This discussion should suggest that alpha is quite hard to generate since most ways of doing so depend on the investment manager possessing unique abilities – to pick stock, identify weaknesses in management and remedy them, or undertake financial innovation. Unique ability is rare. How then do the masses of investment managers justify the faith reposed in them by masses of ordinary investors? The answer is probably liquidity provision, which is the activity that depends least on special managerial ability and could be termed the poor manager's source of alpha.

The problem when the world has excess desired savings relative to investment, and when central banks are accommodative, is that it is awash in liquidity. Many investment managers can enter the business of liquidity provision, and even as they take ever more illiquid positions, they compete away the returns from doing so. The point is that current benign conditions engender "illiquidity seeking" behavior. But they could have worse effects.

5| Tail risk and herding

For what is the manager with relatively limited ability to do when central banks flood the market with liquidity and the rents from liquidity provision are competed away? He could hide risk – that is, pass off returns generated through taking on beta risk as alpha by hiding the extent of beta risk. Since additional risks will generally imply higher returns, managers may take risks that are typically not in their comparison benchmark (and hidden from investors) so as to generate the higher returns to distinguish themselves.

For example, a number of hedge funds, insurance companies, and pension funds have entered the credit derivative market to sell guarantees against a company defaulting. Essentially, these investment managers collect premia in ordinary times from people buying the guarantees. With very small probability, however, the company will default, forcing the guarantor to pay out a large amount. The investment managers are thus selling disaster insurance or, equivalently, taking on "peso" or "tail" risks, which produce a positive return most of the time as compensation for a rare very negative return.[2] These strategies have the appearance of producing very high alphas (high returns for low risk), so managers have an incentive to load up on them, especially when times are good and disaster looks remote.[3] Every once in a while, however, they will blow up. Since true performance can only be estimated over a long period, far exceeding the horizon set by the average manager's incentives, managers will take these risks if they can.

One example of this behavior was observed in 1994, when a number of money market mutual funds in the United States came close to "breaking the buck" (going below a net asset value of USD 1 per share, which is virtually unthinkable for an ostensibly riskless fund). Some money market funds had to be bailed out by their parent companies. The reason they came so close to disaster was because they

2 *Peso risk is named after the strategy of investing in Mexican pesos while shorting the US dollar. This produces a steady return amounting to the interest differential between the two countries, although shadowed by the constant catastrophic risk of a devaluation. Another example of a strategy producing such a pattern of returns is to short deep out-of-the money S&P 500 put options (see Chan, Getmansky, Haas and Lo, 2005).*

3 *Certainly, the pattern of returns of hedge funds following fixed income arbitrage strategies suggested they were selling disaster insurance. The worst average monthly return between 1990 and 1997 was a loss of 2.58 percent, but losses were 6.45 percent in September 1998 and 6.09 percent in October 1998.*

had been employing risky derivatives strategies in order to goose up returns, and these strategies came unstuck in the tail event caused by the Federal Reserve's abrupt rate hike.

While some managers may load up on hidden "tail risk" to look as if they are generating alpha, others know that for the more observable investments or strategies for their portfolio, there is safety in mimicking the investment strategies of competitors – after all, who can be fired when everybody underperforms? In other words, even if they suspect financial assets are overvalued, they know their likely underperformance will be excused if they herd with everyone else.

Both the phenomenon of taking on tail risk and that of herding can reinforce each other during an asset price boom, when investment managers are willing to bear the low probability "tail" risk that asset prices will revert to fundamentals abruptly, and the knowledge that many of their peers are herding on this risk gives them comfort that they will not under perform significantly if boom turns to bust.

6| RISK SEEKING

Times of plentiful liquidity not only induce investment managers to seek illiquidity, tail risk, as well as herd, since they are also times of low interest rates, they may induce more familiar risk seeking behavior. For example, when an insurance company has promised premium holders returns of 6 percent, while the typical matching long-term bond rate is 4 percent, it has no option if it thinks low interest rates are likely to persist, or if it worries about quarterly earnings, but to take on risk, either directly or through investments in alternative assets like hedge funds. Similarly, a pension fund that has well defined long dated obligations will have a greater incentive to boost returns through extra risk when risk free returns are low. All manner of risk premia are driven down by this search for yield and thus risk.

So let me summarize. We are experiencing a widespread phenomenon of high productivity growth, but low investment relative to desired savings, which has pushed down interest rates and pushed up asset prices. With plentiful liquidity, investment managers have reduced the premia for risk as they search for yield. In an attempt to generate alpha, many managers may be taking on beta risk, and even underpricing it. Of course, low interest rates and plentiful access to credit will, for a time, result in low default rates, which will appear to justify the low risk premia. The search for yield and for illiquidity knows no borders as oceans of capital spread across the globe, and asset prices across the globe are being pumped up. As one says in French, "Pourvu que ca dure!"

7| CONSEQUENCES

What could go wrong? Our hope is of a "soft" landing in the real sector where the factors that led to the current real sector imbalances reverse gently – for instance, domestic demand picks up in the non-industrial world, and growth recovers in Europe and Japan, even while tighter financial conditions slow consumption in the United States. As a better balance between desired savings and investment is achieved, interest rates move up slowly, credit becomes less easy (aided by central bank tightening), and illiquidity seeking and risk seeking reverse gently without major blow-ups.

Of course, if any of this happens more abruptly, the consequences could be uglier. I will not belabor the possible risks to the banking system. Indeed, I do think the greater concern has to be about the rest of the financial system, the 80 percent of value added by the financial sector that is outside the banking system. The non-bank sector is increasingly central to economic activity and is not just a passive holder of assets. Moreover, some non-banks such as insurance companies and some hedge funds are subject to runs. But most important, risks to financial stability are invariably compounded by political risk.

Let me explain this last concern. Finance, as Luigi Zingales and I have argued in our book *Saving capitalism from the capitalists*, is never popular. The anti-finance constituency gains especial clout in the aftermath of a financial crisis, and while some of the constraints it imposes on finance may be warranted, some like the Glass-Steagall Act, imposed in the United States after the Crash of 1929, are neither justified by the evidence nor, by most counts, welfare enhancing.

It may well be that today's financial sector comes out of a future political investigation smelling like roses. But I see some ingredients that have me more concerned.

First, the general public's money is being invested in some of the more risky ventures, a fact highlighted by the revelation that a number of state pension funds were invested in a risky hedge fund like Amaranth. Diversification into such alternative investments can be a valuable component of an overall investment strategy if it is carefully thought out. The problem is that all too often, it takes place as a form of herding and late in the game – after lagging pension managers see the wonderful returns in energy, commodities, or from writing credit derivatives made by their more competent or lucky competitors, there is pressure on them to enter the field. They do so late, when the good hedge- or commodity funds are closed to investment, and when the cycle is nearer peak than trough. Myriad new unseasoned hedge or commodity funds are started precisely to exploit the distorted incentives of the pension or insurance fund managers who queue like lemmings to dutifully place the public's money. Thus far losses from isolated failures have been washed away in diversified portfolios and the public has not noticed. Will this always continue?

Second, the fees charged by investment managers like hedge funds and private equity cannot but arouse envy. It is surprising that despite the furor over CEO pay, very little angst has been expressed over investment manager pay, even though Kaplan and Rauh (2006) suggest that investment manager pay growth has probably exceeded CEO pay growth.[4] My sense is that there is a belief amongst the public that many investment managers are following sophisticated investment strategies –in other words, that the managers are generating alphas and earning returns for their talents– hence their pay is not questioned.

Yet investigations of collapsed funds such as Long Term Capital Management (LTCM) don't seem to indicate terribly sophisticated strategies –indeed more beta than alpha. While there is a selection bias in examining failed funds –they are likely to have more beta– it is also likely that large funds with unsophisticated strategies got to that size through a series of lucky bets that paid off. So their managers will have taken home enormous sums of money before it is realized that they had simply been gambling with other people's money. Large losses, "greedy" managers, and an angry public– this is a perfect scenario for a muck-raking politician to build a career on. The regulatory impediments that could be imposed on the investment managers who add value, and on the financial sector as a whole, could be debilitating.

Third, and accentuating the political problem, is that while it is clear to the public how a bank making a loan benefits the real economy or "Main Street", it is less clear to it how an investment manager who spreads and allocates risk, improves governance, or reveals information through his trading, helps. We economists know these are very important functions in the economy but they are not so easily sold politically.

And finally, since capital has spread across borders, any sudden future retrenchment could not only inflict pain on recipient countries but also generate foreign political pressure seeking to impede the free flow of capital.

The last few years have been, in many ways, the best of times for the world economy. The financial sector has contributed immensely. However, the current conjuncture has led to some practices that deserve examination. In particular, I worry whether compensation structures give too much incentive to take risk and, relatedly, whether pay is sufficiently linked to performance. Much of the debate has been over whether these are systemic concerns. My point today is that even if the consequences are not collectively important enough to stress enormous economies like those of the United States or the Euro area, if questionable practices are numerous enough, they could stress the political system, which then may react in a way that has systemic consequences. To avoid the risk of possibly excessive political reaction, it is important that the issues that I have just alluded to be discussed by the financial sector itself, and where necessary, and possible, adjustments made. It would be a shame if sparks from the red-hot financial sector set off a conflagration that destroyed the very real gains finance has made in the last few decades. Indeed, history suggests abundant caution.

4 *Kaplan (S.) and Rauh (J.) (2006): "Wall Street and Main Street: what contributes to the rise in the highest incomes?", Working Paper, University of Chicago.*