

Navigating Through Difficult Investment Markets

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My agenda

- What happened?
- Why? (Competing explanations)
- What next? (The easy question)
- Lessons for policy makers and investors

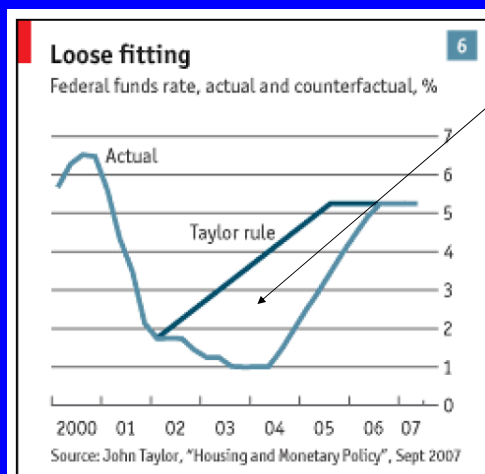
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What happened?

- We are now all experts in sub-prime, CDOs, CDS, house prices and global imbalances.....
- What drove all this?

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One (simple) answer



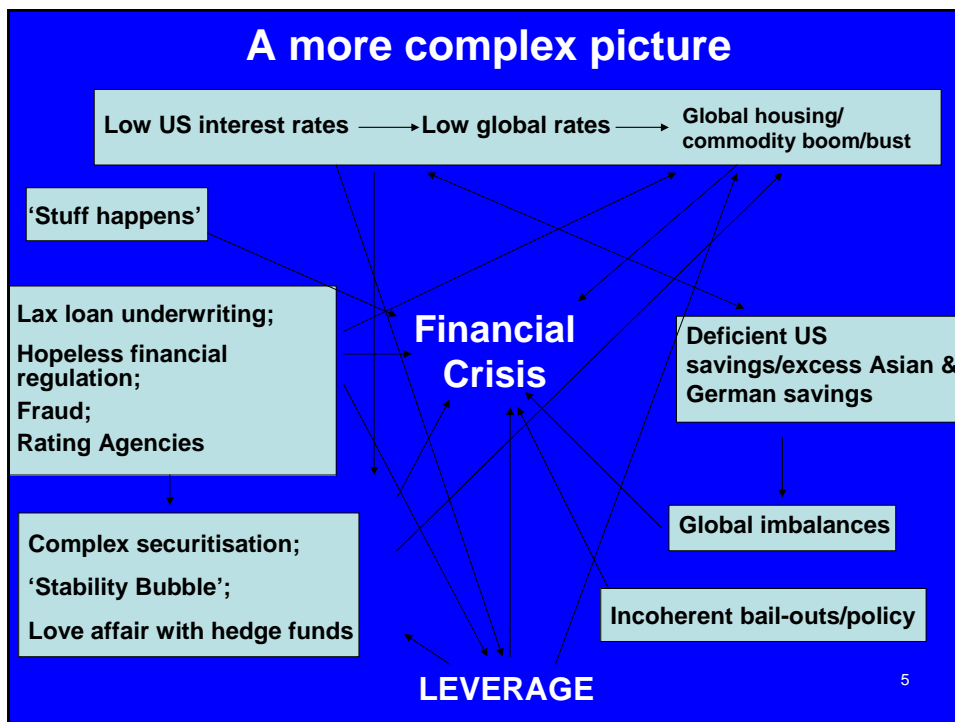
Source: Taken from *The Economist*, Oct 2007

The (big) gap =
where interest rates were
Minus
where they should have been

This was a **HUGE** change
compared to how interest
rates had been set for most
of the previous two decades.

Extremely loose policy
fuelled the US housing boom.
And was replicated in many
other countries.

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- ### What happened to monetary policy?
- In the aftermath of the bursting of the tech bubble, US – and global – monetary policy changed
 - Hubris? ‘The Great Moderation’
 - Fear of deflation?
 - Just a mistake?
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Misaligned incentives

- Regulators: the conveyor belt from the SEC to Wall St
- Rating agencies. The simple question has been asked: 'why do these entities still exist?'
- Executive pay & the mega-bonus culture: *asymmetric risk*

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Misaligned incentives cont'd

- Nobody has any incentive to take the long view or the view of the wider interest.
- '*We are all short termists*' – perhaps. And maybe because some are paid to be. And ethics represent a very different kind of discussion.

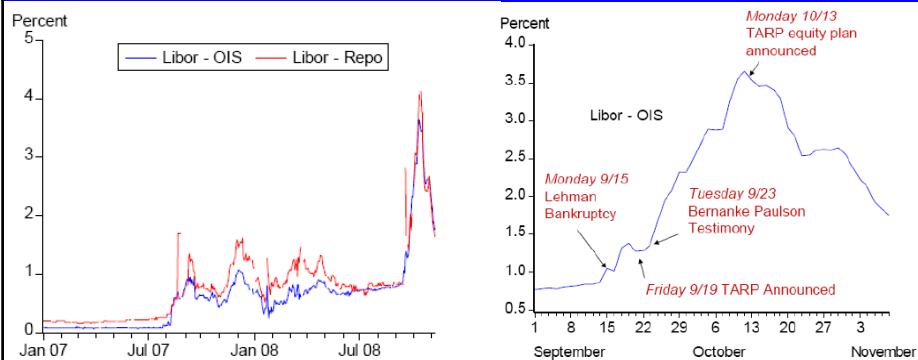
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Misdiagnosis?

- Liquidity problem?
- Counterparty risk?
- The answer drives the policy response
 - ➔ If it is a liquidity problem, then reliquify the system (TAF etc) (& watch commodity prices!)
 - ➔ If it's about counterparty risk, then recapitalise (and deal directly with the problem loans in the housing market)
 - ➔ Policy makers have dithered between the two and dithered over who is, or is not, too big to save
 - ➔ And don't understand the need to increase disclosure

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Counterparty risk, not liquidity or Lehman (blame a 2 ½ page TARP liquidity plan)



Source: John B Taylor: *The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong*, Nov 2008

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Fighting the last war?

- The great depression was in large part a lack-of-liquidity problem, caused mostly by central banks
- Hence, central banks have sprayed the system with liquidity – mostly to no effect
- But counterparty trust needs to be restored: the system must somehow be made to believe in its own creditworthiness

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Reasons to be hopeful

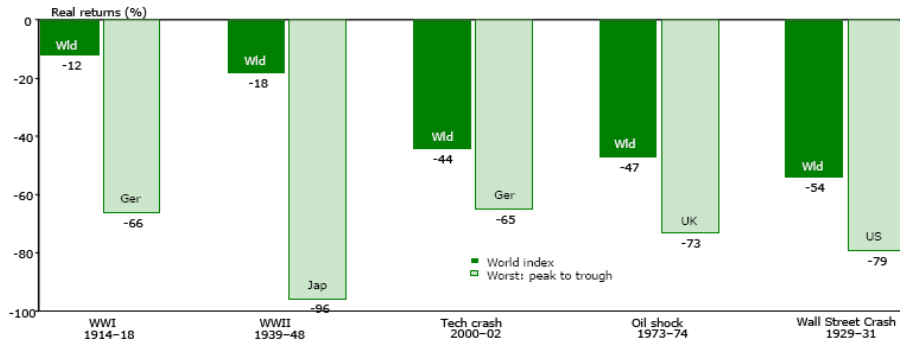
- Obama – and global - stimulus (but is it enough?)
- Policy makers showing some signs of a better understanding of the problems – their mistakes are becoming clear for all to see
- Passage of time

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How bad?

30 Oct 2007 – 8 Jan 2008: MSCI World down ~40% in real terms

Figure 6: Extremes of equity market history, 1900-2007

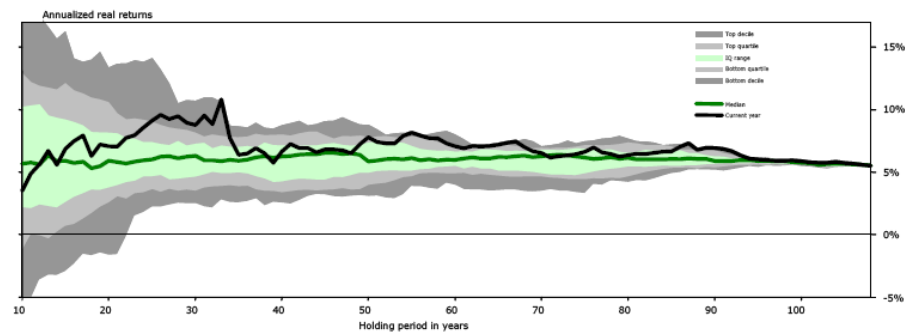


Source: ABN AMRO/LBS Global Investment Returns Yearbook 2008, Table 6

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Asset allocation: what we know (I)

Figure 14: Dispersion of real returns on UK equities over periods of 10-108 years



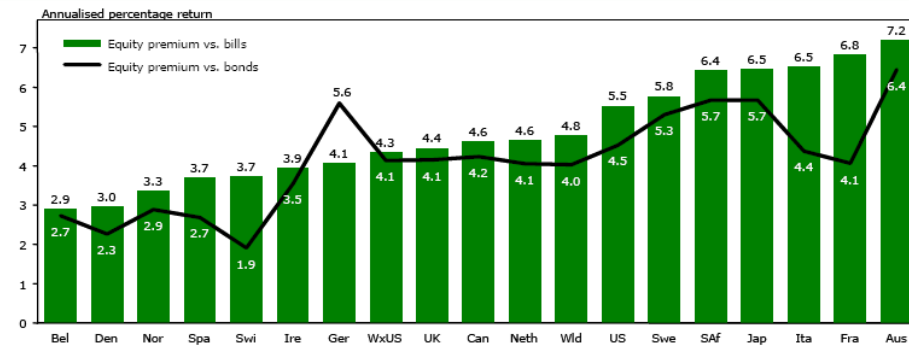
Source: ABN AMRO/LBS Global Investment Returns Yearbook 2008, charts 119

If history is any guide, we have to wait just over 20 years for a *certain* positive real return from stocks. Globally, there is wide dispersion but the number is also close to 20 years.¹⁴

Asset allocation: what we know (II)

- Figure 8 shows the annualised (geometric) equity risk premia realised over the last 108 years.

Figure 8: Worldwide annualised equity risk premia relative to bonds and bills, 1900–2007

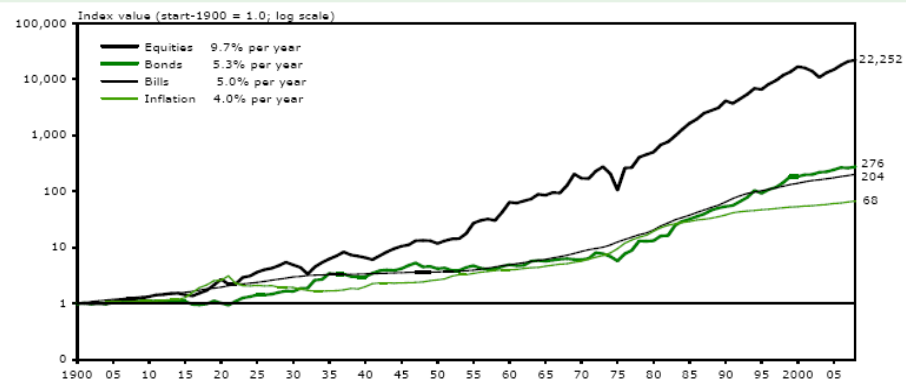


Source: ABN AMRO/LBS Global Investment Returns Yearbook 2008, chart 20

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Asset allocation: what we know (III)

Figure 4: Cumulative returns on UK asset classes in nominal terms, 1900–2007



Source: ABN AMRO/LBS Global Investment Returns Yearbook 2008, chart 12

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Time

- Historically, you have to wait a long time for stocks to deliver. Time, arguably, is one of Buffett's key advantages
- Returns, when they come, always surprise and can be huge
 - Best ever year for real UK equity returns?
 - Best ever year for real global equity returns?

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Answers

Best ever year for real UK equity returns?

1975: +96.7%

Best ever year for real global equity returns?

1933: +69.9%

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But

- Few of us saw this coming – not least the extent of it
- If history teaches us that equities outperform bonds it also teaches us lessons about risk, volatility and time
- And to be humble when making forecasts

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A short digression on forecasting

- ‘Although people endlessly ask for predictions, they rarely really want the answers.....when people ask “we really want you to challenge our ideas” they mostly do not.’
- ‘The market for clairvoyance has existed throughout history and is satisfied by messages based on hope and ambiguity’
- ‘Successful forecasters are distinguished by their television manner rather than by the accuracy of their forecasts.’

John Kay

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What next

- 'At under 1000 on the S&P500, US stocks are very reasonable buys for brave value managers. The same applies to global equities' (*Jeremy Grantham, value investor, bearish for most of the past decade*).

→ *'Brave'? Because the curse of the value manager is always to be early; because the macro is still so awful*

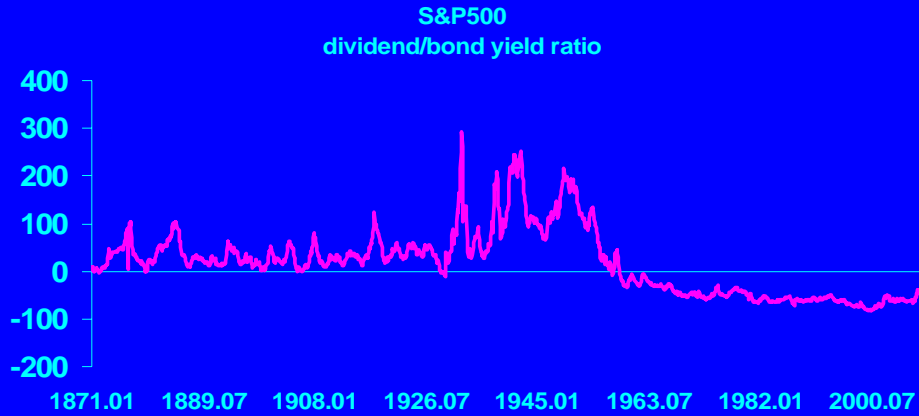
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That valuation debate

- Which metrics?
 - Mean reversion: the antithesis of 'this time it's different'
 - A plea: don't throw the baby out with the bath water
- There are still grounds for thinking that we do some things better than in the past

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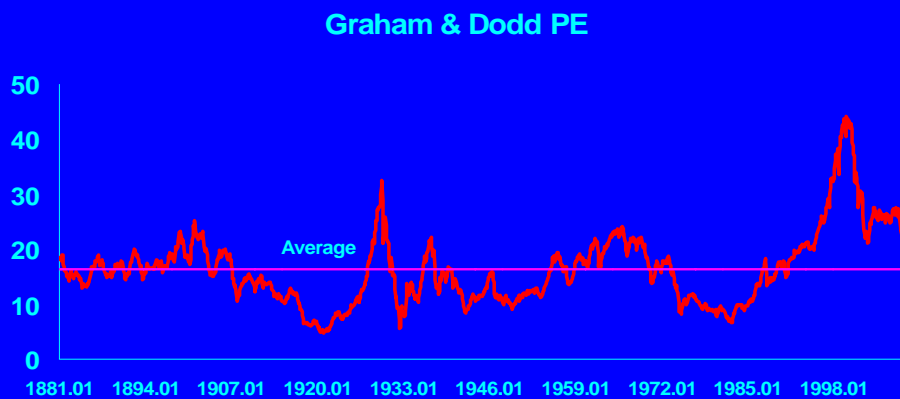
Back to the future? (or just destined never to grow again?)



Source: Robert Shiller/BIAM Estimates

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Mean reversion?



Source: Robert Shiller/BIAM Estimates

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Lessons

- Don't eat something if you don't know what's in it (Kay)
- Align incentives with desired outcomes
- Transparency, clarity & simplicity
- A 'New Capitalism'?
- '...those CEOs who succeed will be those who imbue in their business very simple common sense standards of decency' (Peston)

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