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What a Difference a Decade Makes

Reflecting on the Global Financial Crisis

2008 *2018*

It has been 10 years since the global financial crisis (GFC) took the financial industry—and the real global economy—to the brink of collapse. Companies went bankrupt, investors were traumatized, and many countries and individuals are still recovering a decade later. We recently reflected on the biggest lessons learned, ongoing threats, and sources of new opportunity—now, with 10 years of perspective on what we hope will remain the greatest crisis of our investing careers. The following are excerpts from conversations with several RMB investment team members.[1] »

Looking back to 2008, was there a moment when you realized the magnitude of what was happening?

Dick: When money-market funds broke the buck, it was the first sign there was a really big problem. Normally, money-market funds trade at a dollar—one dollar in is valued at one dollar plus interest. One day, all of a sudden, it was worth less than a dollar. That was really frightening. There was a risk that all money-market funds could unravel. Until the government stepped in, I think things were on the way to that.

Chris: When the House failed to pass TARP[2] on the first try and the markets plummeted immediately, I knew it was something serious. Generally speaking, legislation and fiscal policy have longer-term market impacts rather than short-term reactions. Hence, seeing the markets drop after TARP wasn't passed signaled that the environment was different.

What was the biggest mistake investors made during that time?

Dick: It would be either panic or paralysis. Letting fear drive decisions and not taking advantage of phenomenal, once-in-a-lifetime opportunities to invest in really high-quality companies at the lowest valuations people may ever see. Of course, though, that's easy to say in hindsight.

Egor: In October 2008, investors were trying to find liquidity, and the only assets left that offered such liquidity at the time were high-quality companies with strong cash flows. To meet margin calls against illiquid positions, a lot of people sold stocks of good-quality companies at prices far lower than their fundamental net worth. It was empirical evidence to me of a liquidity crisis at work.

The Federal Reserve brought interest rates down to zero during the crisis, and they have only begun ticking up from the bottom over the last couple of years. How have low interest rates affected markets globally, and when might we see interest rates return to "normal" levels?

Jeff B.: Low interest rates were the tool the Fed used to try to drive wealth creation. In other words, low rates make bonds unattractive to investors, so to achieve the returns they were accustomed to, investors moved assets from the safety of bonds to riskier investments. This helped push equities and most other risk assets to historically high valuations.

As to the second half of your question, the most difficult part is determining what's normal. We've been dealing with the "new normal" for several years now, and it's hard to imagine going back to the "old normal." Now that the Fed has started raising rates again, there are a number of factors it has to be sensitive to—for example, inflation. Throughout the recovery, inflation has been historically low, but with rates rising, we've seen a pickup. The Fed is trying to determine where it can stabilize short-term rates—keeping them low enough to avoid creating a recession and high enough so that inflation doesn't get out of control. The Fed is also trying to assess what a sustainable, long-term rate of inflation is, and investors will have to determine what real rate of return (over and above that) they'll accept. That's how you find a new equilibrium.

Coming out of the crisis, regulators placed a big emphasis on reforming the banking sector. Was that effective, and what have been the repercussions?

Anton: The rules created in the crisis were extremely effective in reducing risk in the banking sector—the amount of capital banks held as a percentage of their total assets rose from 9.3% in 2008 to 12.7% by 2010.[3] But if we were to find fault in these rules, it would be in the regulators' "one size fits all" mentality, which is now being addressed by the newly appointed heads of the CFTC,[4] FDIC, Federal Reserve, OCC,[5] SEC, and Treasury. The efforts to tailor existing regulation by size and complexity make a lot of sense; financial markets would be much worse off if the pendulum were to abruptly swing back and forth. One result of a rationally regulated banking system, though, is the resumption of growth in "shadow banking"—unregulated banking by non-bank »

lenders. We are wary of the growth of non-bank lenders because we believe it's driven by higher hurdle rate private capital pushing further out on the risk spectrum in search of yield.

With banks collapsing their trading desks in the face of heavy regulation, how has that affected market liquidity, and what risks and opportunities does that present?

Evan: The high yield bond market has been historically illiquid. Liquidity was even further reduced by the new Volcker rules, which severely limited banks' ability to trade using their own balance sheets. There are both opportunities and challenges with this new paradigm. With fewer banks now able to buy in times of stress, the potential for an unexpected downdraft has increased—that's the challenge. The opportunity is that we investment firms no longer have as many competitors looking to buy when bond prices drop—the smaller pool of buyers means we may be able to buy at more attractive prices in the future. With the confluence of these events, new phenomena have emerged that favor smaller funds; for example, when passive ETFs become forced sellers, we've cut out the middleman and can set the price at which we want to buy. Overall, it's a positive, it's exciting.

From the March 2009 low, U.S. markets are up nearly 400%. Overseas markets are up a lot, too, but nowhere near as much as the U.S. Why is that, and what could it mean for the future?

Egor: My personal take is that this is due to three things. One is that the markets were stimulated by capital infusion through the very accommodative policies of central banks. The Federal Reserve was among the most aggressive in its capital infusion, followed by the European Central Bank but to a much lesser magnitude, and then, much later, by the Bank of Japan. So, the amount of liquidity poured into the U.S. was higher than it was overseas.

Another point is that the extent of the economic recovery was really much larger in the U.S. The degree of restructuring at the corporate level in the U.S. was much higher, which led to bigger margin expansion and, therefore, larger growth in earnings. But this earnings growth wasn't supported by top-line revenue growth until the last few years. This was happening elsewhere, too, but to a greater degree in the U.S.

Finally, the U.S. dollar has also strengthened. Across Europe, there have been a number of anti-establishment elections and actions—from Brexit in the U.K., to the anti-EU coalition in Italy, to the talks in Spain about trends against the EU, to immigration issues in Greece. These have weakened foreign currencies against the dollar. And remember, if you are measuring the return of a foreign index in U.S. dollars, then it's going to be negatively affected by the recent strength of the dollar.

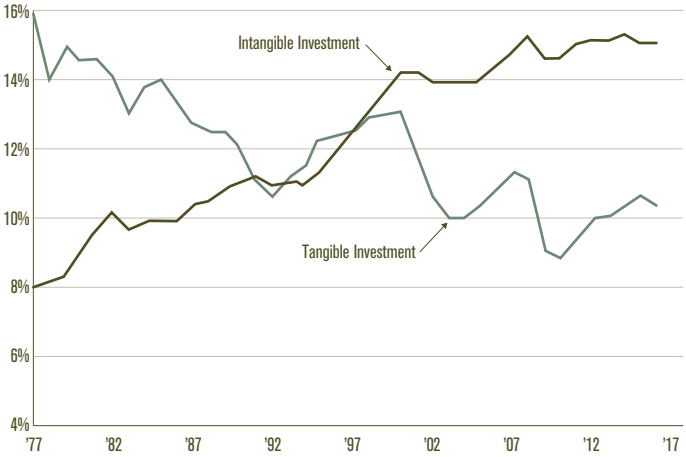
Prior to the global financial crisis, Japan had been suffering from sluggish growth and deflation for nearly 20 years. Its prospects finally seem to have turned around with Prime Minister Abe's three-pronged economic plan, which was unveiled at the end of 2012. What needs to happen for Japan to continue this turnaround into the future and not slip back into its old ways?

Masa: Strong political power to drive the reform initiative is important. In the medium term, this condition is met. Prime Minister Abe just secured his next three-year term as president of his ruling party, keeping him in power until 2021. I believe his next job, along with the ongoing reform efforts, is passing this reform agenda on to the next generation of leadership. In the private sector, we are encouraged by the significant improvement in corporate governance and higher awareness of the need for reform. This strong support will help to prevent a backward shift from the ongoing Abenomics reforms.

Technology stocks have appreciated tremendously over the last few years, particularly the so-called FAANG stocks—Facebook, Apple, Amazon, Netflix, and Google. Is a paradigm shift taking place, or are we repeating the tech bubble of 1999? »

Jeff M.: Since the early 1990s, high-innovation companies, such as Google, Amazon, and Microsoft, invested heavily in intangible assets to the benefit of society in general, and their customers, employees, and shareholders in particular (Exhibit 1).

EXHIBIT 1 THE INTANGIBLES REVOLUTION



Source: Carol Corrado and Charles Hulten: American Economic Review.

In contrast, Sears and many other firms with business-as-usual cultures failed to adapt to this "new economy," and now find themselves undergoing massive layoffs or bankruptcy, and with long-term shareholders and former employees asking, "What went wrong?" The key point is that Generally Accepted Accounting Principles (GAAP)—the standard for financial reporting—generates data that misses value creation in the new economy. For example, Amazon makes extraordinarily large intangible investments, such as in R&D, that will provide future benefits. But GAAP requires full expensing that greatly depresses reported earnings, so the firm's resulting price-to-earnings ratio appears sky high. Identifying companies with high *intangible* value in the new economy requires new thinking about what drives value creation in general, and alpha (excess shareholder returns) in particular. A useful blueprint focuses on three components: managerial skill, a knowledge-building culture, and distinct, adaptable capabilities. We believe some of the popular tech stocks today check all of these boxes—whereas with the 1999 bubble, many tech stocks were simply riding the wave of unreasonable enthusiasm and didn't have the underlying fundamentals to support their valuations.

In your opinion, what are the biggest lessons of the GFC?

Jeff M.: The currency of free markets is trust and integrity. The GFC is a frightful but helpful reminder of what can happen when trust and integrity are eschewed.

Egor: Don't be afraid to make a contrarian bet if your process points at it. The wisdom of crowds doesn't work at the peak of a crisis.

Dick: If you really understand what you own, and focus only on high-quality investments, it's much easier to avoid letting fear take over.

Masa: Act decisively when you think you are right, even if the rest of the world goes against you. ■

1 *Contributors include: Richard M. Burridge Jr., CFP®, Founding Partner, CEO, and Co-Chief Investment Officer (Dick); Christopher M. Graff, CFA, Partner, Co-Chief Investment Officer, Managing Director of Asset Management (Chris); Masakazu Hosomizu, CFA, Partner, Portfolio Manager (Masa); Jeffrey L. Bryden, CFA, S.V.P., Portfolio Manager (Jeff B.); Egor Rybakov, CFA, S.V.P., Portfolio Manager (Egor); Anton V. Schutz, Senior Portfolio Manager (Anton); Evan Dreyfuss, CFA, Portfolio Manager (Evan); and Jeffrey B. Madden, Portfolio Manager (Jeff M.).*

2 *According to the Federal Reserve, the Troubled Asset Relief Program (TARP) was "a series of initiatives to strengthen market stability, improve the strength of financial institutions, and enhance market liquidity" introduced by the U.S. government.*

3 *Bank Capital to Total Assets for United States," Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, accessed November 5, 2018, https://fred.stlouisfed.org/graph/?g=lTAU.*

4 *Commodity Futures Trading Commission.*

5 *Options Clearing Corporation.*