What the financial crisis can teach us about investing

The past five years have highlighted the importance of some long-standing rules

By Christopher Polk

From the end of August 2008 through February 2009, an investment in the FTSE All-Share Index lost roughly a third of its value as markets worldwide crashed, governments bailed out banks, profits plunged, and unemployment spiked. However, since the markets hit bottom in early 2009, that All-Share investment has more than doubled in value. Financial economists will continue to study the 2008-2009 financial crisis and its aftermath for years to come. Nevertheless, there is much that investors can take away now from that experience. These ideas are not new, but the past five years have emphasised their importance.

1. Identify all the risks in your potential investments

Most investors appreciate that equity markets are risky. The sharp decline in world stock markets in late 2008/early 2009 confirmed that view. However, the financial crisis and the fallout afterwards revealed that many investments that may have been thought of as relatively safe by investors were actually far from risk-free. For example, foreign depositors in high-yielding Icesave accounts lost money when Landsbanki, the Icelandic bank that marketed and sold those products, failed in 2008. Greece's debt restructuring in March 2012 underscored the potential for significant default risk in sovereign bonds. An extreme example comes from the structured notes sold by Lehman Brothers that offered "uncapped appreciation potential" along with "100 per cent principal protection". Of course, when Lehman failed in 2008, that promised protection effectively disappeared. Finally, the sharp decline in US house prices that precipitated the drop in worldwide equity markets made it clear that houses are risky investments as well. Investors should carefully consider the risks in the potential investment opportunities they face. Pay attention to default risk, inflation risk, and other sources of uncertainty that are easy to overlook. Be suspicious of "safe" investments offering superior returns.

2. Avoid complexity and minimise cost

As the financial crisis unfolded, even casual investors became aware of the role played by the securitisation of home loans. Mortgage-backed securities enabled capital to flow to housing markets which, before securitisation, had been constrained by local supply and demand. However, the complexity of these securities made them difficult to value. Though the complexity of mortgage-backed securities may be appropriate for sophisticated market participants, the typical investor should be wary of investing in overly complex products, which typically have higher commissions attached to them, providing advisers with an incentive to push those products to their clients. Broadly, investors should be sceptical that they will receive more in returns just be-

Bull market: traders crowd the floor of the New York Stock Exchange, 2010

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cause they pay more in fees. On the contrary, reducing costs is perhaps the easiest way to improve portfolio performance.

3. Do not confuse growth and stock market performance

It may be surprising to see the strong stock market performance since early 2009 unaccompanied by correspondingly strong economic growth. However, the link between economic growth and stock market performance is tenuous. To begin with, growth in GDP can only move markets if the gains accrue primarily to capital rather than labour. Moreover, even if capital receives all of the gains, market returns will be strong only if publicly traded firms are the companies delivering the growth. Furthermore, markets are forward-looking. Even if listed-firm profits are high, returns will be flat if that profitability had been anticipated by market participants. Finally, stock prices move not only because of news about profitability, but also because of news about discount rates. Holding expectations of future profitability constant, stock prices will increase if investors discount those future profits less aggressively. As a consequence, an investor should be careful when basing investment decisions on views about GDP. Just because a country is expected to have strong GDP growth in the future does not mean that its stock market is necessarily a good buy.

4. Pay attention to valuation ratios

Financial economists have shown that low stock prices, relative to a measure of expected cash flow such as dividends or earnings, predict higher subsequent stock returns over the next several years. Since measures of expected cash flow move slowly, as a consequence, after a significant drop in equity prices such as in late 2008/early 2009, valuation ratios tend to fall and expected future returns tend to increase.

Understanding the source of this predictable variation in returns is a hotly-contested debate in financial economics. On the one hand, proponents of efficient markets would argue that the higher expected returns in early 2009 were because risk and/or risk aversion had increased. On the other hand, advocates of behavioural finance would claim that investors were excessively pessimistic and thus stocks were underpriced.

Regardless of the economic reason for the high expected returns in early 2009, if an investor is financially sound and feels comfortable taking on risk when valuation ratios are low, then these times represent buying opportunities. Put simply, investors should not reduce their exposure to equities when market prices are falling just because others are doing so. ▮

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