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Beware of the “Business as Usual” Mindset

By Mohamed El-Erian

This piece is dedicated to the memory of Peter Bernstein, who passed away last week, and to the strength and grace shown by his surviving wife, Barbara.

Our industry has lost one of its few greats. Peter’s deep wisdom and brilliant insights have inspired many generations of financial professionals. Through his penetrating writings and his willingness to question conventional wisdom, Peter advanced our collective knowledge, reminded us of our limitations and cautioned against hubris and overconfidence.

*Peter was also a very good friend of PIMCO. He joined us as a speaker at our Secular Forum, sharing penetrating and thought-provoking insights. His books and regular articles in **Economics and Portfolio Strategy** have become reference volumes for both old and new PIMCO colleagues.*

Peter will be sorely missed. His extremely positive influence on our industry will persist for generations.

Our thoughts are with you, Barbara.

Bill Gross and Mohamed El-Erian

This year may well go down in the history books as combining the best of times and the worst of times for long-term investors keen to position their portfolios for high and sustained risk-adjusted returns over time.

A seemingly wide array of dislocated valuations comes wrapped in what are, under virtually any metric, highly uncertain secular prospects for global financial markets. As a result, the basic approaches investors use to capture superior returns – particularly the trio of the right asset allocation, appropriate investment vehicles, and responsive risk management – are very much in play, as are structural elements of the industry itself.

At the most fundamental level, 2009 is about the interaction of three distinct yet interrelated forces: The sequential healing of financial markets after a series of shocks in 2008 that were fueled by a de-leveraging process of historic proportion; delayed yet virtually inevitable economic and political reactions at both the national and international level; and the partial structural reconfiguration of the economic, financial and political landscape – again within and across borders.

Accordingly, and by necessity, investors today are navigating a bumpy journey to a different destination, which we at PIMCO have called a “new normal.” A challenging element of the journey

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is determining how to best reconcile short-term imperatives that, while valid, also conflict with longer-term realities. The specification of the destination is also difficult, given the “resetting” of variables that were previously deemed parameters – or partial anchors – of market-based systems and behaviors.

An Inconvenient Reality

A high analytical hurdle should always be applied to any notion that a financial system will not revert to its most recent “mean.” Similarly, firms should question hypotheses that suggest that, following a shock, markets will not revert to “business as usual.” And policymakers should always treat with suspicion forecasters who suggest that the potency of traditional policy measures is changing.

Yet, even when applying these high standards, it is difficult to dismiss the view that we are in the midst of a regime change. Specifically, there is reason to believe that – once the immediate waves of dislocation associated with what Bill Gross has labeled the DDR (de-leveraging, de-globalization and re-regulation) run their course – investors and policymakers will find themselves in a landscape that only partially resembles that which dominated the 2003–2007 period.

This is particularly consequential for long-term investors. Their advantageous structural attributes (and the nature of their liabilities and implicit/explicit contracts) allow them to exploit long-term secular trends that can prove particularly remunerative in a world where other financial market participants are acting in a more short-term-oriented fashion.

The fluidity of today’s world is so unusual that the phenomenon is also relevant for “relative value investors” – a group who, before 2008, felt confident dismissing large macro issues. After the experience of last year, there is now broader appreciation even within this group that seemingly market-neutral trades can become highly directional when some key parameters of the market system are suddenly in flux.

Accordingly, for all involved, we may well be living in a world where the answers to a few basic questions will determine how best to navigate the bumpy journey and position for the new normal. Indeed – whether it is known or not – investors (and policymakers) are in fact taking a view on these issues, either through action or inaction.

Now here is an important rub. In addressing these questions explicitly, I suspect that some of us (if not most of us) will be pulled away from our comfort zones. Even more unsettling is how we may be pressed to question elements of approaches that, over the years, have become conventional wisdom and, in turn, dictated many institutional processes, human resources, system designs and operational relationships.

Identifying Some Basic Questions

Let me suggest that the answers to the following four questions will likely imply some changes in mindsets, approaches and institutional setups. And, if this proves correct, let me also suggest that early movers will gain an advantage that could be invaluable as the world bumpily transitions from the old to a new normal.

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1) How far will the balance shift away from markets and toward governments?

There is no doubt that we are in the midst of a shift that is seeing governments in industrial countries become more involved in the modes of production, exchange and distribution. Ironically, the rate of change is most notable in the U.S. Just think of AIG, Bank of America, Citi, Freddie and Fannie, GM, TALF, TARP, etc. – all this in a country that has long been committed to minimum state involvement in economic and financial activities, and that was able to credibly lecture others on the virtues of limiting the role of government.

My colleague, Paul McCulley, refers to this as a shift from the invisible hand of the markets to the visible fist of governments. By definition, the drivers of greater government involvement in markets are non-commercial. The catalyst for entry is often triggered by the desire to offset market failures and limit related collateral damage. The exit is often delayed by political lobbying by those who are favorably impacted by government interventions.

Policymakers face three distinct challenges on this count. First, their market interventions must be accompanied by a clear notion of when and how they will get out. Second, they must manage their involvement with an eye on minimizing disruptions to the normal functioning of markets and incentives. Third, they must be able to identify and address the adverse unintended consequences of their actions. History suggests that most governments tend to be unable and/or unwilling to meet these challenges in a decisive and timely manner.

These considerations translate readily into the task facing long-term investors. Think of it in this rather simplified manner: In designing our portfolios, we look to maximize exposures to risk factors that are attractively priced and minimize exposures to unattractively priced factors. We are conventionally trained to analyze a traditional list of risk factors that includes equity, inflation, inter-temporal and liquidity. Now we have to add a public policy risk factor. Incorporating this properly into asset allocation and risk management can, on its own, make the difference between solid and disappointing returns.

2) How will governments finance their growing involvement in the economy?

At first this does not seem like a big issue. After all, fiscal stimulus and market intervention reflect the need for the public sector's balance sheet to compensate for the sharp and disorderly contraction of the private sector's balance sheet. But, with time, markets will worry increasingly about the longer-term cost of high and growing public sector borrowing requirements. Indeed, it is already starting to happen.

Again, this is a particularly important issue for the U.S. The jump in the 12-month financing requirement is huge, amounting to at least four times the highest previous level. It is coming at a time when foreign holders in particular already have significant exposure to U.S. assets. It is also coming at a time when the U.S. Treasury has declared its intention to reverse a worrying multi-year trend that has seen the average life of government debt fall to 48 months, or its lowest level (i.e., most vulnerable) since the early 1980s. Whichever way you look at it, a massive amount of government duration will be hitting markets.

Policymakers must find a way to upgrade their liability management approaches consistent with the paradigm shift in the public finance area. They must also credibly signal their intention to

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return to longer-term fiscal sustainability through the generation of meaningful primary budgetary surpluses. We are already seeing some strain on both counts, and we will see even greater stress in the quarters to come.

This will serve to magnify the role of governments in influencing both absolute and relative values in several market segments. Yet the impact is not as straightforward as one may first believe. For example, we also have the Federal Reserve in the picture by virtue of its emergency programs to buy Treasuries, Agencies and mortgages in the secondary markets. Just think, there are now two non-commercial players on different sides of the bid/offer in benchmark markets that also influence the leveraged financing of other instruments further down the risk spectrum. The implications for portfolio positioning are far from trivial.

3) To what extent will this alter the role of the U.S. in the global economy?

The U.S. supplies two “public goods” that are key parameters for the global system and impact the effectiveness of policies and the positioning of portfolios. Indeed, until recently, very few questioned the wisdom of 1) relying on the U.S. dollar as the global reserve currency, and 2) outsourcing financial intermediation functions to what have been viewed as deep and predictable U.S. financial markets.

For the U.S., as the provider of these public goods, this has resulted in lower funding costs and greater macro-policy flexibility. In other words, the U.S. has operated like a large closed economy even though it is an increasingly open economy that is gradually losing its size advantage (especially relative to fast-growing emerging economies).

For investors, this has translated into a large exposure to U.S. investment instruments, particularly when compared to what would be justified on account of other economic and financial factors. This is not about global de-coupling versus re-coupling, as interesting as that debate is. It is much more fundamental, because it is about reassessing the robustness of largely unquestioned elements of structural portfolio constructs – or, if you like, what had served as a starting point for many investors’ asset allocation exercises.

This is part of a much broader phenomenon that increases the fluidity of the new normal. The credibility of the Anglo-Saxon model is under threat; countries that operate under this model can no longer play the role of an effective magnet for global convergence. Yet there are no ready substitutes that are able and willing to step in.

In such a world, asset allocations must retain an important element of agility and flexibility. Indeed, the historical concept of a relatively rigid policy portfolio must now incorporate much greater optionality – an issue that Peter Bernstein has brilliantly addressed in some of his recent writings. At the minimum, we should expect the “special opportunity” category to become more than just a residual in the periodic assessment of a portfolio. Similarly, proper and dedicated resources must continue to be devoted to what was hitherto seen as the highly routine task of cash and collateral management.

Similarly, look for diversification to be seen for what it is in such a world: a highly necessary, but far from sufficient, mitigator of risk. In a world of changing and unstable “correlations” (think asset

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class variances and co-variances), much greater emphasis must be placed on the adaptability of other elements of risk management – particularly the design and implementation of an active program of cost-effective tail risk hedging.

4) How far will governments go in de-risking the financial system?

The economic crisis of 2009, characterized by high and rising unemployment and social suffering, is a direct result of the financial crisis of 2008. This is increasingly apparent to many people, including politicians who will face important elections over the next couple of years (including Germany, the U.K. and the U.S. midterms). The result will be a massive politically-driven de-risking of financial systems, especially now that the market-led de-leveraging process is abating.

We should expect a permanent reduction in the extent and diversity of the credit that lubricates economic activity. The endogenous liquidity factories that worked overtime in 2005–2007 will be shadows of their former selves. This will be felt in the range of activities that can be readily financed, it will act as another factor to lower the potential rate of growth for economies such as the U.S. and U.K., and it will contribute to a significant consolidation of the investment management industry.

Have no doubt about it, we are in the midst of a reconfiguration of the industry. It is most acute for those entities that previously relied on a heavy dose of leverage, such as private equity and hedge funds. Gone are the days when virtually anyone could set up shop in this space. Only the talented and large firms will be able to easily navigate the new normal with the degree of confidence that was abundant in this sector just a couple of years ago.

Other parts of the financial industry will also feel the winds of change and consolidation. In their eagerness to shed “non-core” activities, banks will continue to dispose of their asset management arms. Barclays’s sale of BGI is an illustration of a more general phenomenon.

This market consolidation is particularly challenging for those investors who outsource the day-to-day implementation of their asset allocation. In today’s world, the robustness of the business model – or, more accurately, the lack thereof – can dominate the soundness of the investment teams. This is just one example of the extent to which the concept of “manager risk” must assume a much broader dimension in a fluid industry.

Concluding Remarks

Most investment professionals I meet are no longer hesitant to talk about experiences they had last year. The phenomenon is reminiscent of a group that, having survived a near-death experience, now feels the need (and has the confidence) to talk about it.

This is understandable. The recurrent shocks and related disorientation that were so common last year have given way to a greater sense of stability and predictability in financial markets. Yet it would be wrong to conclude that we are returning to “business as usual.” The next few quarters will be dominated by the aftershocks, driven not by a financial system in disarray but by the slower process of structural adaptation of the real economy, the political system and the financial services industry itself.

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We are facing a world of lower growth and accelerated country realignments. Policy experimentation will remain the norm for much longer than most expect. Governments will act as marginal price setters in many markets. The endogenous credit lubrication process will be curtailed for years to come. And yet, inflationary expectations could eventually deteriorate as the potential growth rate for the U.S. comes down.

All of this constitutes an inherent part of the world's bumpy journey to a new normal. It is a reality that also impacts key elements of successful investment management – in particular, asset allocation, manager selection and risk management. It calls for some critical re-tooling of mindsets, institutions and approaches. It challenges traditional comfort zones.

Inevitably, some will resist such a re-tooling. After all, it is difficult and risky, and it involves a non-negligible degree of uncertainty. Others will embrace the re-tooling challenge, and in doing so thoughtfully and responsively, they are likely to gain an important first-mover advantage.

A summary version of this article appears in the June 16 edition of the Financial Times.

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