Investment - Commentary No. 184

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Flight to Quality

"The ever so popular interconnections of asset rich Japanese companies... are revealing themselves more and more as a swamp of unknown depth which threatens the entire system." Investment Commentary No. 167 of July 4th 1995)

1. *Happy Holidays!*

As the end of 1997 is fast approaching, we believe that we have every reason to look back with satisfaction unto a most challenging year, quite apart from the fact that it may soon be time for best wishes for the holidays anyway. We do not mean this cynically, even after all the turbulence in the financial markets triggered by the "Asian crisis". And it is not meant in an overly self-satisfied way either, just because a cautious stance lead to being affected only marginally resulting in minor injuries. This would be too cheap. This type of "malicious joy" does not fit well into the holiday spirit anyway.

Our best wishes are extended with the most honest of intents: We have reason to be satisfied not despite the "Asian crisis" but exactly *because* of it. Year in and year out we are betting on the financial markets being efficient systems for pricing economic assets. It is therefore always reassuring when we receive confirmation that this is indeed so, that in the intermediate to long run prices will reflect economic values. We disagree with all those analysts who not only believe that markets are inefficient but are furthermore convinced that they alone are able to use this inefficiency to their advantage. It is true, that to some extent the markets are always inefficient, since transactions are not costless and not all market participants have access to the same information. And there are indeed some who have a better nose than others and they deserve to enjoy the truffles they find.

We are not of the opinion that markets are as inefficient as generally believed. And we certainly do not believe that we can systematically utilize potential inefficiencies to our advantage. All our efforts are geared towards finding investments which are traded in a well functioning market yielding a fair value return - we are not looking for excess returns due to inefficiencies. Worlds separate the two positions; the differences are ultimately philosophical.

> ***Flight to Quantity***
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> As this commentary was going to press we received the news of the merger between the two Swiss banks, UBS and SBC Warburg to become "United Bank of Switzerland". Now even the Swiss will have to realize that the pressures of globalization will entail extraordinary measures. Switzerland is no island, quite the opposite is true! Whether this move by two of the three largest Swiss banks is indeed the right response remains to be seen. It is a flight into size, to combine a shear unmeasurable quantity of capital, people, assets under management etc. For the moment we are left with the slightly queasy feeling that here an entire generation has thrown in the towel since they saw themselves incapable of independent solutions, which indeed they may have been.
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> One thing is clear: on the way to the gigantic mega-bank a number of well functioning client relationships of many years will be left behind. This offers opportunities for smaller competitors who are better able to take advantage of their proximity to the clients. The structural change in the Swiss banking sectors is only just beginning.

This may sound somewhat academic, but it is of such fundamental concern that a major of this bulletin will be devoted to this topic. Let us begin with an intuitive example which we have put forth several times before. For many years, at least since the "surprising" interest rate increase of 1994 we have stated that the bond markets have become very efficient, and that they in effect dictate the limits of independent monetary policy. Our these of much increased efficiency was based on a careful observation of the bond markets in general and of the Futures and SWAP markets in particular. The ability to react very rapidly to even the smallest changes in the monetary environment makes bond markets to a "feed-back" system which influences monetary policy in ever better (i.e. finer and more differentiated) ways.

On this observation we based our interest rate prediction. In essence we claimed that the recurring spikes in interest rates would result, over time, in constant to declining interest rates. We would therefore have been most concerned had we not observed interest rate "humps" time and again. The absence of such temporary interest rate increases would have been a sign that the feed-back mechanism was not working or was, in fact, inexistent. Since 1995 there have been at least three such interest rate "humps" and media and analysts have routinely mistaken them for trend reversals.

In nature there are large numbers of such feed-back mechanisms, some infinitely more complicated. Whether it be the pancreas, the brain stem or the any other organ of the human body: a system of checks and balances lives off the interactions of changes. That reactions may manifest themselves occasionally in spurts is known from these systems as well. Spurts, "crashes" and turbulence are not indications of a malfunctioning system. In what follows we will review again what happened in Asia. Nevertheless, or better: just because of this, we have reason to wish you happy holidays. Rejoice ! The system is functioning.

2. *A brief Recap*

Recall briefly the events of the past few months. *First:* an unparalleled increase in equity prices in Europe and in the US despite occasional inflation and interest rate fears in the face of robust if not excessive growth in the US. In Europe we have observed a remarkable convergence of macro economic variable, albeit at a very low level of economic growth. The large multinationals are pursuing successful restructuring strategies while the small and medium firms focussed on Europe fail to enjoy any recovery.

Second: Euphoria about economic growth in the markets of South East Asia, where some GDP growth rates are in double digits. Transfer of political power in Hong Kong. Emerging doubts about China's ability to tolerate "two systems" and to accept the finer details of an open market system. Signs of an emerging exchange crisis among the "Tiger" countries who had tied their currency to the Dollar for too long.

Third: Continuing and worsening stagnation in Japan despite interest rates at record low levels and years of fiscal stimulation packages. Real estate crisis, deflationary monetary policy (excess supply, very low credit volume), high volatility of the Nikkei stock at very low levels (i.e. at about on third of historic tops).

Fourth: finally the dam bursts starting in the third quarter of 1997, engulfing first the "Tiger" currencies and then, dramatically, the local stock markets. It comes to a (preliminary) end in a number of bank failures and hastily constructed IMF aid packages.

A few numbers: The Tokyo stock exchange has lost 19 percent in Swiss francs since the beginning of 1997. Thailand's stock market has lost 69%, Malaysia 65% and Korea 52%. In the US one earned 33% over the same period, in Switzerland 49%(!) and in Germany 34%. The differences could not be clearer.

3. *Pseudocapitalism*

It does not lack a certain irony that yesterday's darling of economic policy commentators fails to leave negative headlines behind. We still remember the courses and seminary taught at well renowned business schools on both sides of the Atlantic proclaiming the supposed superiority of the Japanese economic system. Nothing, absolutely is left from this admiration. Quite to the contrary.

To fully appreciate the extent of the Japanese debacle[1] one has to go back quite far in history, all the way to the thirties. At this time the relatively capitalistic economy of Japan was

[1] The following reflections are essentially based on a special report in "the Economist" of June 1997

converted into a nationalist-socialist system under the apparently fascinating impression created by the Soviet planned economy. Important elements of the system where interest rate controls, mandatory mortgaging of credits (which was equivalent to companies raising credits in capital markets), a limit on corporate profits and similar dirigistic policies. As a result the Japanese economy was operating under the dictate of a small number of holding structures which in turn were closely connected to ruling elite.

After the war the victorious Americans broke the holding structures as these were closely tied to the financing machinery that fed the Japanese armaments industry. To avoid a recurrence, holding companies were outlawed which led to two unintended effects. First: the vacuum left by the holding companies was quickly filled by the ministry of finance, endowing this ministry with powers that are unique up to this day, and second: the structures tying companies to their mother holdings were replaced by an intransparent system of informal channels and crossholdings. The "Zaibatsu" (holdings) were replaced by the "keiretsu", precisely the type of closely knit relationships which were so much admired in the West.

In addition, the all powerful ministry o finance regulated the flow of funds from the (frugal) Japanese population to the capital hungry corporations. Savers were granted tax privileges, but they were also deprived of any choice in savings and investments. Investing abroad was impossible anyway. The corporate credit business was given as a virtual monopoly to three banks, the Industrial Bank of Japan, the Long Term Credit Ban and the Nippon Credit Bank. Only these banks were allowed to make five year loans (note the magic number five as in "socialist five-year plan"). The three banks thus essentially replaced the capital market. Thanks to the high rate of savings (what else could the Japanese do then save) the corporations by this system obtained relatively cheap financing.

The ample flow of funds relieved the Japanese managers of e need to compete in the market for the necessary financing for their corporations or even having to fight for it against competitors. This gave them a significant advantage relative to their western counterparts for quite a few years. For Japanese companies a direct phone line into the ministry o finance was all they needed to assure their companies financial future. At the same time western mangers had to put up with such unpleasant matters as 16% interest rates (e.g. in USD in 1979) for corporate bonds. Instead of good relations to the mandarins in the ministry of finance they had to remain on good terms with rating agencies and financial analysts. These tend to be more sensitive to balance sheets and income statements rather than friendly "presents" or outright bribes...

The largely retained earnings, themselves the result of a lop-sided tax policy, made generous allocations to research and development projects possible. But it also led to a formation of reserves which to our eyes is way out of proportion. Real estate heavy asset monsters with very low earnings rates, business banks with mindlessly overblown credits outstanding, correspond mammoth balance sheets and extremely low margins were the logical result of these policies.

And this is essentially all there is to Japanese financial history in the twentieth century. When the globalization came this archaic planned economy system, which in the truest sense of the word has remained stuck in its "national-socialistic" past ad no chance. Collapse of the Japanese stockmarket, a since 1989 ongoing event, has entailed a massive erosion of apparent "substance" in real estate (and bank balance sheets), a downgrading of the currency and a fundamental reappraisal of the Japanese economy.

There is no need to stress that the Japanese system, which over the years has been slightly loosened but which has remained in its essentials a planned economy system, has brought forth in its decline some fruits of the more unpleasant kind. Controlled markets and corruption are twins, two sides of the same coin. "Investigations against Japanese brokers" (5.6.97), "Nomura must be punished" (16.7.97), "Dai Itchy Kangyo Bank fined"(29.7.97), "Daiwa Offices Searched" (19.9.97, all citations from "Nee Searcher Setting") - there has been no shortage of writings on the wall!

A free thinking human will be hard pressed to find tears for the old Japanese system of intransparent networks in the service of a few inefficient corporate behemoths. The almost limitless absorption of the employees and there entire private life, the mandatory morning gymnastics, the solemnly chanted company hymn are all symbols which cause (or at least should cause) allergic reactions among those believing in the rights of man as an individual. They are clear signs of the subordination of the individual in a totalitarian regime - a mindset never quite liberated from the strictures of fascism. It may have been exactly these characteristics which have lead to such admiration, especially in Europe. Right here among us, among people who in their deepest inside are also not quite free yet from this type of thought and ideology.

4. *Jungle - Capitalism*

Inseparably linked to the very special history of Japan is the rise and apparent fall of the „Tiger" economies which had been so successful during the past few years. On the one hand there exists an economic link to the misallocation of resources in the Japanese system. Without the absurd urge to finance projects which has been prevalent in Japanese banks for many years, a significant number of prestige „white Elephant" projects in Korea, Taiwan, Malaysia, Singapore and the Philippines would never have been built. On the other hand it is likely that numerous gigantic conglomerates have been modeled along the lines of the Japanese gigantic corporations like Sumitomo, Sanyo or Mitsubishi.

Equally important for the analysis of the situation in the countries cited above is the imbalance between the highly technicised production sector on the one hand, and the social and political sectors on the other hand. Over time it is just not possible to implant modern production techniques onto local structures which are still quite archaic. Even in the so-called industrialized countries the resulting stresses are enormous, despite an apparent slight head start relative to South East Asia. This is by no means intended to belittle the situation. Non-Democratic, anti-liberal societies certainly have some advantages. The combination with modern Capitalism, however, makes for an explosive cocktail.

Most obvious in this context is the unfortunate Web of economic and political interests which leads to intransparent, often corrupt Conglomerates. But it is precisely these often gigantic enterprises which enter the financial markets seeking capital. It is their shares that we find in the „Tiger" funds and of which only one thing is known: The investor is pulled across the table by all means imaginable.

The justifiable goal of investing in the economic growth of these countries as investor is thus subverted in that most investible funds raise abroad go to the very sectors and companies that contribute least to economic growth: the large gray area between economy and state. The „Economist" reports that the five largest conglomerates in Korea are on average active in 140 different areas. The combination of Japanese „conglomerate" thinking with the growth pressures of the region is at the very core of the problems of Asia. The powerful cartels devoured systematically any and all successful private companies until all that was left after some time were a small number of over-dimensioned dinosaurs; and in the case of South Korea an external debt of approx. 120 Billion Dollars.

True growth, however, and with it the chances of the entire region, lie on a completely different plane: In small and medium sized companies where people directly responsible and interested work, work hard (probably harder than most people in the West), and certainly much harder than the local bosses and elites in the penthouses of Kuala Lumpur, Singapore, Bangkok or Seoul.

5. *Socialization or Amelioration?*

Whenever international financial markets adjust rapidly to more realistic price levels and overblown bubbles implode the questions is raised whether the turbulence might not sink the entire system. The usual answer to the supposed „dangers to the system" is the aid of a lender of last resort. In domestic markets it is usually the central banks who fulfill this role, in the international context it is the International Monetary Fund (IMF) that takes over this role.

So far the management of the Asian crisis has followed exactly this script. In the case of Yamaichi it was the bank of Japan that stepped in to protect the lenders; in the case of Korea the IMF has just announced an assistance amounting to USD 50 Billion. Such packages are usually tied to stringent conditions intended to restructure the economy. One of the results is often an austerity program which may be quite painful for the population, and which is intended to rebalance the fiscal deficits and rectify the external ones. The IMF or their delegates are then charged with supervising the implementation of the conditions.

Of course one accepts the need for such crisis management models and is usually relieved when after acceptance of such a program the turbulence in the financial markets is (temporarily) under control. But one should not lose sight of a small but important point: Assistance from the IMF is in and off itself *not a free market tool*, and if the borrower turns out to be incapable of repaying the IMF loans the costs of the system and transferred to an indeterminate number of institutions, governments, countries and their Taxpayers, i.e. the future risks are being „socialized".

Societies willingness to accept these risks should thus always be linked to the IMF program being coupled with a through „cleaning" program. In Japan, as well as in the „tiger" countries this can mean only one thing: real (and truly effective!) deregulation, reform of the banking system even if this entails further large corrections of collateral values, forced liquidation of bankrupt conglomerates, break-up of the semi governmental corporations and reprivatization of the individual pieces worth keeping.

Our willingness to invest in the area again in the future is thus less a function of technical indicators signaling „oversold" on some stockmarkets and thus „predicting a recovery anyway, but of whether one or the other country is willing to expose its economy to the rigors of the free market. It may sound perverse but is nevertheless logical: every new bankruptcy in Korea, Japan and similar countries increases our willingness to consider these markets as interesting investment opportunities.

6. *Concerning Financial Viability*

The turbulence emanating from the Asian crisis have shown a very fundamental point: In the final analysis most projects in Japan and in the so-called „Tiger" countries were not really financially viable. This raises an additional point: What do we mean by „financial viability"?

- Financial markets are in essence equilibration- and transmission mechanisms. Put fless academically: The equilibration of prices assures that the assessment of those willing to sell, and thus inclined to weigh negative information more heavily, intersects with those willing to buy and thus inclined to weigh positive information more heavily. One cannot overestimate the information generating function of financial markets. If, however, financial markets in some countries are illiquid (or manipulate!) so that the resulting prices do not reflect an information equilibrium, then one of the preconditions of „financial market" worthy of the name is missing.
- Furthermore, information must be obtainable in relatively simple (i.e. inexpensive) ways. This is not the case were transparency is lacking. This shortcoming increases transactions costs and ultimately leads to illiquid markets.
- Financial markets depend to a large degree on a secure legal environment, especially secure property rights. Both, formal expropriation, and „indirect" expropriation will over time hurt financial viability.
- The demand for a low level of graft and corruption goes in the same direction. Corruption is economically a special case of an „agency problem", the contradiction in the incentives of the „owner" and his/her „agents". Whether these collect on their own behalf, or on the behalf of organized crime or government official higher up has no influence on the damage cause to the „owner", i.e. the taxpayer. Simple economics teaches us that „agency problems" can never be completely eliminated. But for financial markets it must be clearly considered as one of the prime problems. Which enrichment, which bonus, which provision is justified and legal and which not is a

question which must be solved and which must be part of a constant struggle with lawmaking and justice.

- Finally it is important that *economically unproductive allocation mechanisms* be absent. Basically financial markets are certainly able to deal with many official redistribution mechanisms such as (progressive) tax rates and subsidies. But where governmental interference has for years directed resources in the wrong direction a strong potential for a massive correction is built up. When this potential unloads we have rapid shifts and crashes such as we have seen recently in Asia.

Financial markets lack adequate means to defend themselves against asymmetric information distribution, insecure property rights, graft, corruption and the directed misallocation of resources. This does not mean that financial markets would not expand into countries and regions where such conditions prevail. Especially in liquid market situations, i.e. when large inflows of funds are seeking higher returns, markets tend to self delusion in believing fundamental conditions are sufficient to make viable financial markets possible. Politically inspired protection mechanisms, such as currency pegs, foster the illusion of secure financial market environments for some time. But in the end they only lead to even more brutal adjustments once reality sets in. Market economy is, as (Friedrich August von) Hayek has stated time and again, a system of trial and error, and the longer the period during which the errors are hidden through interventionists trade-craft, the more terrible the end.

7. *De-Securitisation as a Consequence?*

Obviously the current weaknesses of the financial market environment in Asia, in particular the established „traditions" of graft, insufficient transparency, inadequate legal security etc., will not change over night; even though we believe that precisely crises such as the present one ought to help those seeking changes.

There exists a portion of the economic refinancing needs which cannot be met by the financial markets, or only with difficulty: i.e. that portion of financing which is better suited to traditional credit financing. It is not irrelevant, whether a sum is owed to a bank or to a large number of anonymous market participants. „Debit" is not simply equal to „debit" when the debtor is of economically relevant size. Whether anyone will ever repay his/her debts in full may very well depend on the relationship between debtor and creditor. Wherever this relationship plays an important role, classical bank credit financing is the superior alternative, where sums involved and the number of lenders is large anonymous financial markets are more appropriate.

There are business banks which for years have been conducting business successfully in „difficult" countries such as India, Pakistan, Thailand etc., i.e. with little to moderate loan losses. At the same time, financial market investors in the very same countries have often been left empty handed. Why? Because these business banks succeed in building a relationship to their borrowing clients which is rich in all the aspects of human interactions. This enables them to have access to additional information which anonymous financial market participants will never have. For example information concerning possible collateral in the Caribbean or on the channel islands...

Financial markets always try to protect themselves with the same obvious instrument: They limit the term of the loan to a few years at most. Short term financing on the passive side, however, is poison for any economy. It lowers the willingness to invest. Well operating long term credit relationships, where lenders and borrowers know each other personally, are in a much better position to fulfill the need for long term financing.

It is therefor entirely possible, that in the coming few years we will observe a tendency away from financial market financing towards more traditional credit business. This tendency towards de-securitisation will be strongest in those areas where investors have made the worst experiences. At the same time we will observe an increased importance of companies internal financing, possibly paired with venture capital financing. All this has consequences for the formulation of the investment strategy for an diversified international portfolio.

8. *Quality is where...*

Let us return to our claim at the beginning: We have reason to whish each other „Happy Holidays!". The system is well and operating as it should. In fact exactly *because* it finally(!) has brought about the overdue re-valuation of the economies, currencies and enterprises which must have been suspect for many years to those believing in economic reality rather than in continuing economic miracles.

„Economic Reality": This is our definition of „Quality". Economic reality can be found wherever the market daily, hourly each minute reaches new equilibrium prices based on all the available information. Where the large number of participants assures that no detail, no matter how small, is being forgotten or lost. In those situation we also know what we may expect over the medium- to long run: Normal risk adjusted returns! We know that assuming a credit risk deserves a risk premium, and equity financing is more risky but also yields significantly higher returns over time.

We therefor concentrate more and more our investments in those areas where we expect market forces to play the most important role. That this Disqualifies most Swiss and European equities does not bother us. The necessary diversification is achieved by a higher exposure to US equities, a market which is much more closely related to our vision of a good" free market than Europe. In our currency allocation we have clearly reduced the area which appears to us most suspect with respect to future misallocation and dirigiste intervention: the entire EURO area. We have little regard for „constructivism" in economics, and the EURO is clearly a „construct".

And investments in emerging markets? One should participate in the still significant economic growth in the emerging markets in Asia and Latin America? Yes, one should! But we would rather do this indirectly rather than through direct investments or, even worse, through equity or bond funds. We like to obtain exposure to these markets through investments in multi-national companies that have been active in these markets for some time. Only a small portion of Nestlé's sales are now in Switzerland, a much large portion is in emerging markets. Holderbank produces and sells cement successfully in developing countries with large infrastructure projects. ABB builds power-stations wherever electricity consumption is still growing rapidly. Why not let those take care of business in emerging markets who have done it successfully for many years. The financial markets in their home countries will assure that their errors and mistakes remain limited.

Yes the system is operating well.

Happy Holidays!

KH, 16.12.97