# Assets: maintenance or development?

### 1. Stuff to keep us awake at night

Private bankers concerning with the development of their clients' assets are currently being confronted with three superficially hardly related questions:

- Were the hiccups on the financial markets over the past two months simply a temporary phenomenon with little impact on long-term development – a brief summer storm, as it were – or are we facing a series of further disturbances, which might indicate the need for a more cautious approach, and indeed for effective rainwear?
- Is the development of the global financial system showing any signs that would indicate the need for a much more fundamental re-think of current strategies? What about the much complained-of "excessive liquidity" and the potential risks it presents for the financial system? Is there such a thing as "asset inflation"? And where might we discover other, potentially more dangerous sources of inflation?
- What should we make of the trend towards giving every conceivable and inconceivable agency access to position and transaction data within the financial system? What is the significance of the attacks on financial privacy in an overall context, and what, specifically, might be their impact on wealthy individuals? Is it just the SWIFT payment system that functions like a sieve, or are there other, still unidentified means of access to databases?

In what follows, we shall endeavor not merely to look more profoundly at these questions, but also to find some answers. For it cannot be the purpose of an investment commentary to cause sleepless nights. Tossing and turning in bed is no fun, even in the present warm summer temperatures. It should rather try to create some assurance that, whatever unpleasantnesses the world may come up with, we can sleep the tranquil and restorative sleep of the (more or less) just.

### 2. Back to normal – what does that mean?

It has been clear for some time that the almost monotonously positive developments on the stock markets since the big slump of 2001-2003 would sooner or later come to an end. It is, however, difficult to identify the precise moment at which the trend changes, and even if we could claim to have pointed at more or less the right moment to the worsening signals (Investment Commentary No. 242 "The best of times, the worst of times", 22 May 2006), we are all too well aware of the fact that between such insights and the courage to take concrete action lies the fear of missing out on additional opportunities to generate returns. And this for readily comprehensible reasons. For those who changed course too quickly, for instance from a markedly stock-friendly tactical allocation to a highly cautious approach featuring many fixed-interest investments will certainly have done no better so far this year. The following table shows the returns achieved so far from typical Swiss portfolios with low, medium and high exposure to stocks.

**Strategy-unrelated performance?**

| Pictet benchmarks | 2006 returns |
|---|---|
| Pictet BVG 25 | -1.80% |
| Pictet BVG 40 | -1.30% |
| Pictet BVG 60 | -0.80% |

Source: Bloomberg

Six of one, half a dozen of the other, unless one had changed relatively late, that is, in April or May, from one tactical allocation to the other. If only one had: material here for success stories over a drink at the pub. Real-world investments look a bit different, and rather less fun. This is because, apart from the zero returns from stocks, bond prices have also taken a pasting, well into the area of seriously short-term investments, and in practically all relevant currencies. At the same time, the risk premiums for low-quality debt, and particularly for certain emerging economies, have also risen. With consistently negative developments, the much praised strategy of diversification has for once not paid off. So, nowhere is there likely to be unrestrained joy over the returns achieved.

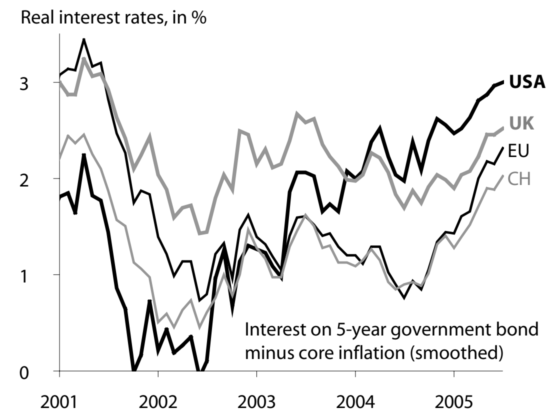
Let's be clear: this too is part of normal investment activity – it's within the normal range, and must be accepted as such. Nevertheless, we rightly raise the question of likely future developments. The disillusionment on the financial market has played out against a background of almost ideal macro- and microeconomic conditions. Thus, as the financial markets are believed to have anticipatory powers, there is a fear that the depression on Wall Street will be followed by deteriorating conditions in the (real-time) economics of Main Street.

Let's look at some of these "almost ideal" conditions. The economies of by far the most regions of the world are growing at high percentage rates. South-East Asia is in the lead, with well over 5 percent, followed by the USA at some 4 percent, and then the core European countries, which seem to be waking up out of their lethargic doze, and will achieve some 2 percent, this year at least. Inflation rates are very low, generally, in absolute terms and from a historical perspective. Even in emerging economies that were until very recently accustomed to inflation rates of 50 percent and more, a rise of over 10 percent now sets off a state of alarm on the part of the relevant monetary authorities. Accordingly, nominal interest rates remain low; private and entrepreneurial projects can be financed on very attractive terms, particularly as risk premiums, apart from the recent rise for obvious junk quality, are also very low. The currency situation is astoundingly stable. The US dollar, for example, has kept within a range from 1.20 to 1.30 against the euro for the last thirty months. And the yen, a difficult currency to understand, has hardly been outside the range of 115 to 105 to the US dollar since 2003. The international traffic in goods and services naturally profits from such relative consistency.

The overall business situation is also excellent, both in absolute terms and historically. High profits, comfortable margins, sound balance sheets, a liquid market environment for acquisitions and for access to the capital market, weakly positioned trades unions and global outsourcing skills strengthened by experience. What more, what better could one wish?

We must however realize that all these excellent macro- and microeconomic conditions have come about under exceptional monetary circumstances, and that these exceptional circumstances are coming to an end. For some three years, real interest rates have been low, or even almost negative. "Real interest rates" are of course distinctly virtual in nature – banks charge nominal rates, and bond coupons are nominal – and only reflect an assumption about the real price of money. But they do very well as an indicator of monetary conditions. The rule in recent years has been low nominal rates coupled with low inflation and attractive economic growth.

**Money is getting more expensive**




Source: Bloomberg, analysis

Our readers are well aware that we regard external, real factors as being principally responsible for this surely unique conjunction of attractive conditions. The globalization-related possibility of finding ever more attractive production locations has so far stifled any price rises on the labor market. The epochal progress in information and communication technology has resulted in productivity increases in the service-oriented developed countries that have meant that shortages of capacity, and thus excessive overheating of the economy, have been no more than theoretical possibilities.

These actual conditions will not change that quickly. The potential for the global optimization of production in the industrial sector has not yet been fully exploited (North Korea, for example, is currently being discovered as a low-cost country, though "slavery" might be a more appropriate catchword here …), nor are we much more than at the start of the IT revolution. Inflationary pressure is almost impossible under these conditions. Proof of this theory may be found in the way that the economies of the OECD countries have coped without problem with the rise in the price of oil. Under any other macroeconomic circumstances the wage/price spiral would have inevitably started to accelerate.

Nevertheless, the central banks, and the Fed in particular, have been systematically raising nominal interest rates for some time now. Given the low rate of inflation and the still lower expectations on inflation (for example, measured in terms of the price of inflation-protected bonds), real interest rates are rising significantly and money is getting more expensive. The central banks are

undoubtedly keen to dispel a priori any suspicions that the generally highly attractive situation might be endangered through monetary negligence. Both their rhetoric and their activities are clearly directed to this end. And at the same time, the aim is to do away as far as possible with the side-effects of cheap money. These side-effects will be addressed in Section 3.

The turbulence in the wake of remarks by Ben Bernanke, the new head of the Fed, has shown that it is not so easy to achieve both these aims simultaneously. As interest rates, most unusually, are not being raised against a background of economic overheating and high rates, there is a fear that putting too much pressure on interest rates might strangle or at least seriously restrict the highly positive economic developments. A faulty interpretation or an excessively anxious assessment of factor price changes might result in monetary overcontrol; furthermore inflationary rhetoric on the part of the central banks may fuel any prevailing expectations on inflation.

Similar tones, not infrequently also politically motivated, are also heard with regard to comments by Jean-Claude Trichet, head of the ECB. What matters now is to avoid any premature pruning of the fragile plant of European recovery. Well, there have always been proponents of accommodating monetary policy, which is why we have seen, practically all around the world, the institution of independent monetary authorities, which, armed with a very thick skin, and at a remove from quotidian political considerations, can get on undisturbed with their own business. But the advocates of "easy money" are right about one thing at least: there really is no inflationary pressure – not on consumer prices, nor by way of inflationary expectations reflected in inflation-protected financial products.

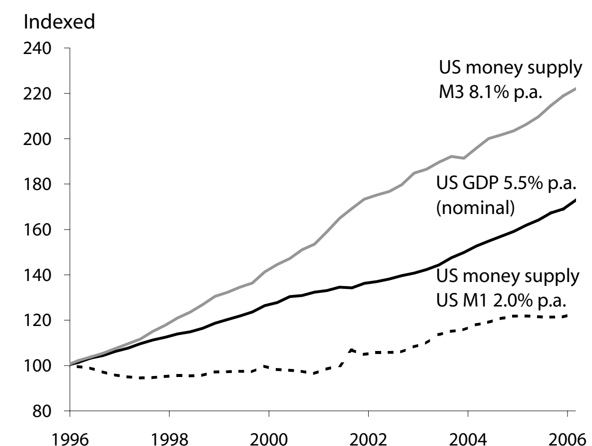
The "normalization" of interest rates, as the central banks like to refer to it, in order not to have to use the expression "interest rate hike" more frequently than absolutely necessary, is taking place in circumstances for which there is really no precedent. This is the problem of the past couple of months, and also probably the problem for some months to come. There is, however, a further problem with this "normalization". Some of these extremely attractive macro- and microeconomic conditions, such as company margins or the shift, observable for some time now, in the benefits of economic growth towards the investor rather than the employee, might also get a bit "normalized" as part of this "normalization" of real interest rates – that is, might drop back to average, or even below-average rates. We know that in the USA the P/E ratio has been falling for some time, from 25 to 40 to a level between 10 and 20. Excellent profits have meant that this drop in the P/E ratio has so far caused no significant fall in share prices. But further, significant "normalization" might well occur via the denominator. No wonder that the financial markets are uneasy!

### 3. Overliquidity

Enthusiasts for conspiracy theories of every variety have long been of the opinion that far "too much" liquidity is being pumped into the system, and that "they" (which usually means mainly the Americans) intend to flood the world with paper money. Ultimately the American dollar – and with it the American debt – would be worthless, and this would be no accident, but an act of deliberate cynicism. Supporters of such theories have benefited from continuing low nominal and real interest rates. Many talk of a "flood of liquidity" often without really knowing what "liquidity" actually is, and even more often without any idea of what "*over*liquidity" might be. How can one determine that there is too much of some thing when one does not even know what the "something" is?

The classic means for central banks to manage liquidity are by setting short-term interest rates, at which the commercial banks can get money, in currency market operations, which also indirectly determine the interest rates for short-term money, and in the definition of the necessary reserves that the banking system must have available. The extent of the prescribed reserves determines the amount of lending the banks can do, and thus the multiplicator for the money supply available to the economy. The various money supply aggregates – basic money supply, M1, M2 und M3 – reflect this mechanism. The only aggregate the central banks can manage effectively is the basic money supply.

**Money supply: differing growth rates**

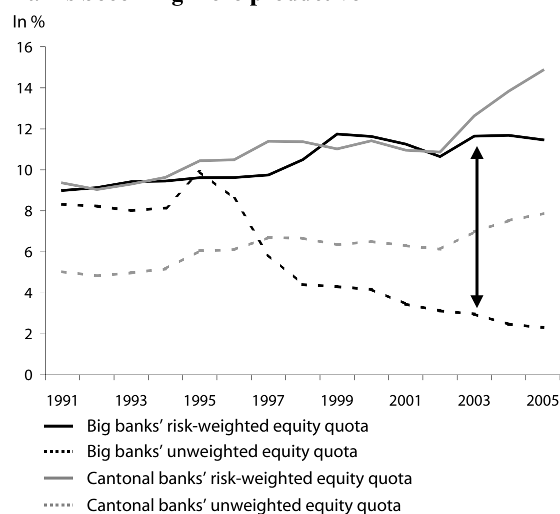



Source: Bloomberg, analysis

Not even as a critical observer can one really claim that the monetary policy of the relevant central banks, measured in terms of the aggregate they can manage directly, has gotten out of control. Such a statement would be more applicable perhaps to the LTCM and Russia crises of 1998. In general, however, the basic money supply and M1 have moved within reasonable ranges. Thus, the fact that the extended M2 and M3 aggregates have grown more strongly than GDP cannot be attributed to an accommodating monetary policy on the part of the central banks.

We locate the reason for the rapid growth of the extended money supply in a profound structural change in the financial system. What does this mean? By way of an example, the figure below shows the extent to which the two big Swiss banks, Credit Suisse and UBS, have been able to manage their balance sheets more effectively. Far greater business volume has been generated for each reserve franc deployed than previously. A very agreeable state of affairs for the banks concerned. What is noteworthy is the difference between the two big banks and the cantonal banks used for comparative purposes. The latter have been able to generate significantly less business volume relative to the equity deployed. It is obviously the case that enormous and broadly diversified balance sheets enable better management than comparatively small balance sheets: there are, then, "economies of scale" here. The extent to which the available equity can be exploited also probably depends on the effort put into balance sheet management, and the system selected.

**Banks becoming more productive**




Source: Swiss National Bank

Notes:
Risk-weighted equity quota: Creditable equity (1. Core capital = paid-in capital, reserves and profits, 2. Supplementary capital = undisclosed reserves, subordinate debt and certain hybrid instruments and 3. Additional capital = special liabilities with freezes) in percent of the risk-weighted assets (on-balance-sheet assets, off-balance-sheet transactions and other open trading positions).

Unweighted equity quota: Creditable equity in percent of the balance-sheet total.

Something else is also noteworthy, but only on reading the footnote. The term used is "risk-weighted"; in other words, we are concerned with balance sheet positions not in the strict accounting sense, but from a probability perspective. The lower the risk appears, the lower the balance sheet position; the higher the correlation of two risks, the higher, because "more dangerous", the valuation in a "risk-weighted" balance sheet. The probabilities in risk weighting are based on certain models, that are mostly oriented on a normal Gaussian distribution. It is important to note that probability models are in no way a representation of reality, but rather feasible assumptions.

But what does balance sheet management from a probability perspective actually mean? Undoubtedly the reduction of unnecessary or expensive on-balance-sheet risks, but also the outsourcing of risks to other risk carriers. Herein lies the structural change in the financial system over recent years. Firstly, it has become possible to identify balance sheet risks adequately, to estimate them continually, and to balance them against one another; secondly, it has become possible to outsource parts of the balance sheet – to socialize the risks, so to speak. It is therefore necessary to be careful when using such ancient expressions as "banks' credit activities". Who is active here; who is carrying the risk? It is probably the case that we have all to some minor extent become banks, and if credit derivatives (financial instruments based on credit risks) gain further ground, this will be still more the case.

Is this a good thing or a bad thing? The question is as otiose as one regarding the value of the rear-view mirror on a car. Its invention or introduction made motor traffic on the one hand safer, because it became possible to look behind one, but on the other hand faster, because it then became safe to overtake slower vehicles. The rear-view mirror, an instrument for identifying risks from behind, was a precondition for the construction of motorways, which resulted in the transformation of a capillary-like traffic infrastructure into a modern infrastructure. Is faster less good? If accidents result, undoubtedly, but not otherwise. Without rear-view mirrors, there would be no motorways. Minor technical developments can bring about major structural change.

## 4. What if?

The attempt to raise real interest rates has been accompanied by the central banks' efforts to limit the side-effects of the uniquely attractive macro-

and microeconomic conditions. The aim is to suck liquidity out of the system, or, to use the motorway image again, to use petrol prices to dampen motorists' excessive enjoyment of their new freedom. Given the structural changes – the enormously efficient, motorway-like communication channels of the financial system – it is however, questionable whether this will be successful, and if so, at what price. For the time being, the engine of the financial system is still roaring away at full throttle. "Leverage" is the magic word: it has taken over the whole hedge fund world, derivatives trading, the private equity scene, and it is particularly rampant in American real estate, where mortgages of 100 percent of the value of the property are no exception.

There is a school of thought which, far removed from conspiracy theories, takes the view that the structural facilitation of leverage will result in a far too high level of debt, in overall economic terms. Leverage is a sweetly flavored poison, a drug that is almost irresistible when everyone else is taking it. The financial system as it is currently structured, and as it will develop with credit derivatives, is not in a position itself to control the total economic leverage. The central banks' control of credit activity is only indirect, and very limited, so it will not serve as a tool for controlling the traffic on the new motorway network.

The collapse of the system on endogenous grounds, while not exactly forecasted, is at least regarded as more likely than it was before the structural change to the financial system. The danger of a real bubble of excessive credit developing is exemplified by developments in the USA, where, in the last five years, disposable household assets have risen by 34 percent, real estate values by 80 percent, and mortgage debt by almost 90 percent. It is obvious enough that a rise in interest rates after such developments will have unpleasant consequences, because in addition to the raised interest costs, the value of the mortgaged property is likely to fall, and the number of bankruptcies to rise. Similar unpleasant circumstances are also conceivable for securities-based credit, where more and more wholly illiquid securities (private equity!) have been granted credit.

According to the theory, much too cheap money has resulted in a regular feeding frenzy, for both private real estate and financial assets. This is the saga of overliquidity and asset inflation. How far it really makes sense, and how far it should be incorporated into considerations on the development and maintenance of assets is, in all honesty, impossible to say. On the one hand, one could argue that the structural changes in the financial system have resulted in a better distribution of risk. A situation of better distributed risks is preferable, in terms of system stability, to a situation in which the whole load is carried by the balance sheets of a few big banks. On the other hand, the anxiety-raising considerations about "overliquidity" and "asset inflation" cannot be entirely dismissed. Since 2001, we know well that, even if entirely rational beings are at work, the result can still be excesses and the formation of bubbles. If the phenomenon of chasing one's tail were to affect the core of the financial system – credit – and not just the technology stocks sector, that would indeed be extremely alarming. Our recommendations for investors in such a situation are set out in section 6.

## 5. Inflated promises

Apart from the breathtaking structural changes in the financial system, a situation has arisen in the social arena that also increases overall economic leverage – and possibly in an even more dangerous manner. More dangerous in that the incentives for rectifying the situation are exceedingly slight. We have on several occasions pointed to the implicit indebtedness of the pension systems in the Western welfare states, and must now return to this topic, with renewed emphasis. Unlike the voluntarily and deliberately incurred debt in the financial system, whose consequences are largely individually borne, debt in the social system is a compulsory mechanism, which nobody can avoid, unless they emigrate. The figure below shows the debt mountains built up by the European welfare states over the past decades. We are informed by the appropriate sources that the figures have not been updated since 1995, "because this was no longer desired". That says all we need to know about the explosiveness of the issue.

**Explicit and implicit national debt in % of GDP (1995)**

Source: seco/Die Volkswirtschaft, analysis

An indication of how dramatic the situation has become may be found in the estimate by the German Bundesbank of the Federal Republic's explicit and implicit debt in 2005. The figure is 270 percent of GDP. The implicit debt of a pension system includes the gap between future promised payments and the future revenue of the welfare systems, based on the (overwhelmingly pay-as-you-go-based) financing mechanisms. In political and economic terms, these debt mountains represent pension cheques handed out to existing generations of voters at the expense of future generations yet unborn. A blatant deficiency in the constitutional protection of the unborn has permitted the development of such a snowball system, which will continue functioning until the devil takes the hindmost – i.e. the ever-decreasing number of offspring refuse to go on paying.

The map below shows how badly the European welfare systems are equipped for the looming system crisis. It shows the available pension assets in the various countries of Europe in relation to the relevant value creation. Putting the maps side by side shows that very few European countries have only a minor problem or none at all: Iceland, Ireland, the United Kingdom, Holland, Denmark, Switzerland, and possibly also Norway on account of its oil reserves.

**Pension assets in % of GDP (2005)**

> 100%
20% - 100%
< 20%

Source: OECD, analysis

This is not the place to draw political conclusions from this rather peculiar geography lesson. However, for those involved in developing and maintaining assets, it must be emphasized that the collapse of the bubble of inflated promises will hardly be unaccompanied by serious effects and side effects. More yet: in this situation assets would be seriously endangered, by either confiscation or devaluation.

**6. Devaluation as a possible scenario**

Both the overall economic aspects of excessive debt that we have described – the possibility of greater leverage due to structural change in the financial system and the possibility of shifting social payment obligations onto future generations, due to the lack of constitutional constraints – may no longer be able to be contained by the system. It is very difficult to depict such systemic crises in detail. The insolvency of one or more of the big investment banks, set off by a Refco/Bawag-type error, but on a much larger scale? The insolvency of a hopelessly overindebted European state like Italy. It is impossible to tell.

But if something like this happened, there would of course be a temptation to "stop the gap" by means of a bail-out by the central banks, accompanied by a massive expansion in the money supply. Inflation would then be inevitable, as would a massive drop in the value of the currency concerned, never mind the bonds. Undoubtedly a worrying and dangerous scenario, that investors would be effectively unable to avoid, regardless of diversification strategies. But at the same time, a fairly improbable scenario, and above all, one whose timing is entirely impossible to forecast.

This results in a conflict of objectives in terms of asset development and maintenance. It is reasonable to anticipate the occurrence of the more probable case. In this situation, ways and means must be found (or occur in some fashion) for the excesses to disappear, more or less cooperatively, of their own accord. Within these normal scenarios, with more probable cases, the focus must then be on developing assets, using every means at one's disposal: that is, by exploiting all the blessings of the modern financial system, and diversifying widely within this system.

At the same time, however, given that we have identified and described certain endogenous systemic risks, we must not neglect the improbable, but extremely dangerous case of a systemic crisis. Here, we must seek means to maintain assets. We have had extensive discussions on this in our bank in recent months. The outcome is that we are advising our clients to protect themselves against the improbable but dangerous case of systemic crisis with a portion of physical gold. It is highly likely that in the event of a crisis in the financial system, gold would gain dramatically in value, as it is not subject to inflation, and largely beyond the reach of politics. Gold is also easily transportable, and suitable as a means of payment in a crisis, provided one does not turn up with 10-kilogram bars.

Our advice is to allocate some 5 percent of total assets to this purpose, and to keep it in a separate deposit, not subject to the performance assessment of the other assets. This 5 percent would be unlikely to fully compensate for the losses from a system collapse, but it would at least provide some cover. And on the other hand, 5 percent of total assets will not endanger the performance of the remaining assets, not least as gold is not such a bad investment medium over the long term. It is, in our view, important to opt for the physical ownership of the gold. For if the system collapses, claims against the issuers of gold instruments will be of little use. And as mentioned, it should be in such a form that, if the worst happens, it can serve as a means of payment. We recommend fungible 1-kilogram bars.

We have no wish with this recommendation to sound like prophets of doom. Au contraire. We take the view that the appropriate and bearable "insurance" of an improbable but extremely dangerous risk to the rest (the greatest part) of one's investments will generate the sangfroid that is needed to successfully develop one's assets. We have, as a matter of course, fire insurance on our houses; without such we would not willingly barbecue in summer or light the candles on the Christmas tree in winter. Insurance, reserves, are an integral part of the freedom of maneuver that we need.

## 7. Data access and confiscation

"Performance" is all, modern private bankers claim. Of course, asset development is undoubtedly important, and is a core task for our profession. But, all our enthusiasm for the search for "alpha" and "beta" performance notwithstanding, we need to be careful not to neglect the much more difficult issue of asset maintenance. It is not only more difficult, but also less agreeable, for who is keen to discuss catastrophe scenarios, or measures that incur costs in an attempt to protect oneself from what are only potential, and mostly fairly improbable situations? However, a historical perspective on asset management reveals that over time, most assets are squandered, diluted, destroyed or simply confiscated. How many aristocrats' palaces survived the French Revolution? What private assets were not wholly devalued by the hyperinflation in Germany in 1923? Who, in the 1930s and 1940s, could escape the waves of devaluation? How many of the art treasures stolen from Jewish families were really returned, and which museums are still sitting quietly on stolen goods? How many Americans lost none of their purchasing power with the fall in the value of the dollar after the collapse of the Bretton Woods system in 1973?

Objectively speaking, the probability of being deprived of one's assets, by one means or another, over time is not inconsiderable. Debt mountains, of the sort we encountered in section 5, are of course predestined to serve as some sort of legitimation for a confiscatory strike. The cry would then go up of "asset harmonization" between prosperous and poor countries and individuals, under the title of "pension assurance legislation", or some such.

There is at the moment fierce discussion in Switzerland of the CIA's access to data in the SWIFT transaction database. We warned our clients at a very early stage, in fact immediately after the terror strikes in September 2001, of the danger of such actions; and apart from this, we are not overly concerned by this access. For secret services tend to sit on their data, and hardly ever pass it on to other bodies, such as tax authorities. Why is this? Firstly, because every transmission to a less secret body dilutes the value of the material. This does not accord with the self-image of secret services. Secondly, because there is a danger of shooting oneself in the foot. For within secret services, the left hand has no idea what the right hand is doing. But each and every secret service undoubtedly makes use of the international payment system for all sorts of likely and unlikely transactions. So the last thing they will want is tax authorities snooping around. Thirdly and lastly, passing on information might compromise some prominent person at home or abroad, which might prove to have undesirably explosive consequences for the secret service.

Far more dangerous in the longer term are the possibilities of access by all the other national authorities. It is reported from Brussels (*Handelszeitung*, 28 June 2006) that the EU Commissioner for Justice, Franco Frattini, is demanding, as part of the "Hague Program", the automatic exchange of sensitive data from DNS profiles via fingerprints and telephone numbers to banking data. While some obstacles to this objective may still remain, in the shape of data protection legislation or, in the specifically Swiss context, banking secrecy, we should be under no illusions that there is a megatrend in the direction of control of the financial system by the political sector. And modern IT systems make it possible for all position and transaction data of all the players on the financial markets to be accurately recorded and evaluated. This is being done on the honorable, and apparently all-justifying grounds of the war on international terrorism, business crime, insider trading, child pornography, the arms trade, tax

fraud and even tax evasion – oh yes, and of course, and in the same breath, money laundering. It would be excessively naïve to believe that it will stop here. That is not how the political system works: it wants to use its power to redistribute. Those who have the data know where to look.

Performance is much, but not all. Investors are well advised from time to time to check out their asset developers in terms of their strategies and concepts for wealth preservation.

KH, 10.7.2006