Crisis means clarification

1. No hurricane, but …

We've recently had two problems to solve. Firstly, to find a metaphor that would provide a more or less reasonable explanation for the remarkable developments in the financial markets over the last couple of months. "The perfect storm" had to serve for the last investment commentary, and cannot be reused on account of its consequent lack of entertainment value. In addition, the progress of the financial crisis has revealed that neither the image of a savagely destructive tropical storm, nor that of a light Caribbean breeze, is really accurate. For what is particularly remarkable about this crisis, is that, as the storm still rages (with the largest Swiss bank recently having to write-off CHF 4 billion), a significant part of the world, and in particular many financial market players are acting as if it were business as usual. Currently we are experiencing extreme tensions combined with an air of crisis: alongside markets are buoyant with optimism and full of joyous faces. Is there any justification for the current situation? And if so, are there precedents? Do we have any past experience, lessons from history, as potential guidance for future actions? And of course, is there not a better image than "the perfect storm", which is clearly raging in places, to describe it?

The second problem is comparatively trivial. Those who know our bank more intimately, are aware of our annual tradition of acquainting a circle of people more closely with a Bratwurst from St Gallen. These annual events are held at all our branches, with the real challenge being to find new and plausible parallels between the sausage in question and the banking business, for our guests are not invited to eat sausages entirely without business intent – they should at least gather from the address that they are being entertained by a bank, not a sausage-maker. So, every year, we try to make an early start on formulating an original parallel.

The good news this year is that the solution to problem number two solves problem number one. For there could be no more appropriate metaphor for the current credit market crisis than the sausage and all that goes along with it: its production, its contents, its sale and its – voluntary and culinary or enforced – disposal. Why? A sausage is well known to be a thin, edible skin filled with a mixture of what were previously real pieces of meat. It is, so to speak, a meat derivative. Cured meat, offal, gristle, and possibly also more expensive cuts are processed into an edible with its own characteristics and qualities. There is also no limit to the variety of meat derivatives. However undeniably delicious a St Gallen Bratwurst may be, there is also nothing to be said against a salami or an 'andouillette'. No culture without its sausage and no meat without sausages, either. Meat production – that is, the market for real cuts of meat such as steaks and chops – is entirely interdependent of the production of meat derivatives – that is, the market for sausage products.

There is, however, a significant distinction between meat and sausages. In the one instance, one knows what one has in one's hand; on the other, not necessarily. The consumption of a sausage requires a high level of trust in its manufacturer, and one does not need to be a convinced vegetarian to have some serious reservations about what it might be found to contain from time to time. "What it might be found to contain": this is precisely the question that has for some months been concerning the credit markets, and has indeed brought them to the verge of collapse.

2. … a problem with rotten meat

The developments in the financial system over the past two to three decades have a great deal in common with the development of a gigantic sausage factory. Whereas previously real, individual items – mortgages or loans – were placed as whole cuts – fillets or joints, so to speak – today, they are minced, mixed, seasoned and packaged: something entirely new and different is created and as with sausages there is no limit to their variety, except that instead of Bratwurst, salami and 'andouillette', we are dealing with ABSs (asset-backed securities), CDOs (collateralized debt obligations) or "conduits" (equity-free banks). Indeed, there is no better metaphor for these instruments than the 'andouillette'. Its original ingredients would be unlikely to find buyers as sub-prime cuts of meat; mixed together however,

they are transformed into AAA sausages awaiting eager demand among gourmets. An enormous new market for securitized sausages has emerged over the last twenty or thirty years. The public has obviously acquired a taste for them: indeed it can reasonably be claimed that it is the new securitized sausage market that has enabled a broader cross-section of investors to enter the financial markets at all. Fillet steaks were reserved for the privileged few; sausages are available to the less well-off. Securitization not only affects the now notorious above-mentioned instruments like CDOs and ABSs but index instruments, certificates on baskets of shares, capital protection products and the like also all consist of minced and processed pieces of meat.

Just as it would be absurd, and also regrettable from a culinary point of view, to question sausages' right to exist, it would be equally pointless to deliver a sweeping negative judgment on securitization. The financial system has become enormously more efficient over the past decades; the global economic boom, indeed globalization itself, would have been inconceivable without this increased efficiency in the allocation of capital. The banking system alone – the butcher without the sausage-maker, as it were – would never have been able to meet the demand. It is not to be forgotten that capital allocation via bank balance sheets is not particularly efficient – being able to place finely-minced risks with investors is an infinitely superior approach.

Of great importance however is that sausages can only be sold successfully as long as there is no justified suspicion that rotten meat may have found its way into their production. The more intransparent the sausage, the more vulnerable it is to loss of confidence, and the fear of tainted meat results in collective panic. A buyers' strike affects not only the notoriously unhygienic sausage-makers but the whole sector can be affected by a collapse in demand. All this despite the fact that the real problem may well have been significantly more limited, identifiable and containable. The public cannot be accused of excessive anxiety, for given the typical mixture that goes into a sausage, the level of information is so asymmetric that to desist from further purchases when there is a suspicion of rotten meat is an entirely rational and comprehensible reaction.

So, those who may have wondered why the entire market for credit instruments has suffered a complete collapse over the past months can look for evidence in the meat market. There, collapses in demand of 30 or 40 percent when bad news breaks is nothing unusual – as for instance, with the outbreak of BSE in 2000 and 2001. It is interesting that during the most recent rotten-meat scandal in Germany just 15 percent of the consumers surveyed reacted by (partially) ceasing to buy meat, whereas the consumption of döner meat in Berlin slumped by up to 40 percent. Döner is fairly heavily securitized meat.

There is a rotten-meat problem in the – securitized – international credit business. Its extent is largely known. It is mainly related to certain American mortgages, many of which will not be able to be repaid, and nor will their interest payments be able to be maintained. In itself, this would not be a problem, despite the massive scale. In this line of business, there are by now no butchers left, but only sausage-makers, and it is unclear how many sausage factories are affected. It may even be the case that sausages that have already been sold and are lying in consumers' fridges are infected. The more intransparent the sausage recipe, the more uneasy the feeling. This is why there is at present no market for these sausages, whether they are labelled hedge funds or perhaps something else.

3. Why a positive stock exchange?

Since summer, we have feared that the – predictable – rotten-meat problem in the financial system would affect the whole stock market, for three reasons. Firstly, because the crisis affects the heart of the system – the banks. The system will only work properly when information and transaction costs are low. A lack of trust between players raises these costs significantly, and can even result in a genuine collapse. In August the collapse of the most important American mortgage house, Countryside Financial, appeared imminent. This could have resulted in a much more serious crisis of confidence, with catastrophic impact on the real economy.

The second reason for our anxiety lay in the awareness that the crisis might result in an implicit increase in interest rates of one to two percentage points, due to higher risk premiums, for large parts of the American economy, and possibly other economies as well. The discounting process means that changes in interest rates result in changes in the value of whatever asset depends on interest costs, and someone has to carry the resulting blow. Logically, this is ultimately likely to be the shareholder.

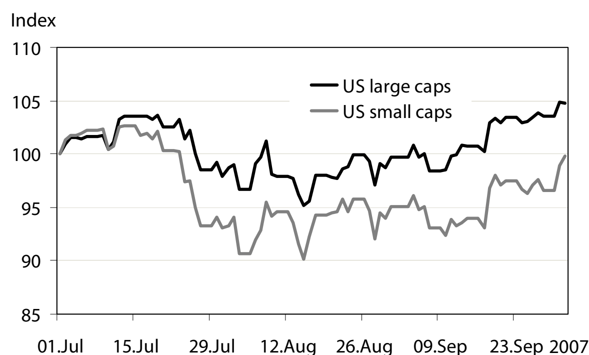
Thirdly, we asked ourselves – as we still do – how infectious the mortgage and real estate crisis would prove for the development of the US economy, and how relevant the development of US GDP is for the global economy. A consumer slump in the USA caused by bankrupt homeowners would, we feared, fairly directly curb production in Asia and result in a reduction of

global investment activity. A “soft landing” or a recession for the USA are the alternatives here. Given that consumer spending makes up at least 70 percent of American gross value added, such concerns cannot simply be dismissed.

Luckily most of these concerns have not materialized or at least only to a minor extent. The big systemic crisis has not occurred. With an extremely clever move with the opening of the otherwise hardly ever used discount window, on 17 August, the Fed created some breathing space for the institutions under pressure, and thus some time to resolve their situations. Accordingly there was no panic selling on the stock markets triggered by margin requirements, as happened in 1987 and 1998. Financial stocks did take a beating on the stock exchanges, more or less all over the world. Bank and insurance stocks, all categorized without differentiation as sausage factories, fell between 10 and 30 percent within a month. But some of this was recovered again in September. The Fed’s prime rate reduction then set-off a real firework display on Wall Street. This is understandable. For only a very little earlier, the markets had been expecting a rise in interest rates, not a drop. The discount effect works both ways.

We need to differentiate however. The increase is not really broadly based, rather, it is the large-cap stocks that are benefiting from the increased demand, while the previously favored stocks of small and medium-sized enterprises remain in disfavor. The figure below clearly shows the differing appetite for various company sizes. The rise is perhaps best interpreted as a flight to stocks of substance, with known content (i.e. not sausage-like). Players are seeking shelter in risk-free government bonds, in stock-market heavy-weights, or in “down to earth” sectors.

A preference for heavyweights



Note: US large caps = Large Cap Russell 50 RTF Index,
US small caps = Small Cap Russell 2000 RTF Index
Source: Russell, Bloomberg, analysis

However, this attempt to explain the undramatic way the crisis has developed is not entirely satisfactory. Lower interest rates are all very well, but whom do they really help? The whole national economy, including the highly pressured homeowners, or perhaps rather just the banks, which can now refinance rather more cheaply, without over-hastily passing this advantage through the system? And how does an economy that is no longer financed directly by the banks function? Is the (short-term) prime rate as relevant to economic growth as has always been alleged in financial circles, or are there not other forces at work of greater importance?

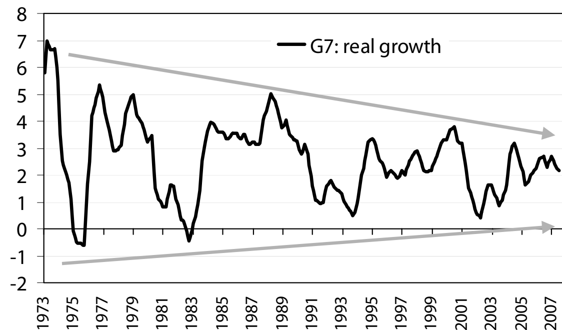
Going further: is it possible that the stability of the financial system has been, and still is being, underestimated? It has been complained that, due to securitization, risks can turn up today in all sorts of predictable and unpredictable places, including in quasi-state institutions in Germany and in the balance sheets of big Swiss banks. There have indeed been some unpleasant surprises here and there. But from a system stability perspective, is this not enormously positive? Has not the crisis so far demonstrated precisely that, in the modern world of meat and sausages, it is possible to keep problems under control when they occur, and to allocate the damage efficiently? If so, the positive developments on the stock exchange since September may be the start of a much longer lasting upwards trend.

We shall look at these two arguments in greater detail below. More specifically, the crises in the context of both the systemic and the real-economy sides of financial markets.

4. Over- and underestimated dependences

It is clear that the future development of the American economy will remain a cause for concern. Our thinking remains affected by the negative experiences of our fathers and grandfathers in the global economic crisis, which was very largely an American crisis, and which encouraged the rise of totalitarian regimes in other parts of the world, and was partly responsible for the catastrophe of the Second World War. But the world has changed radically since then. Interestingly, the far greater international division of labor has not resulted in greater mutual interdependence but rather, in an unbundling of growth rates. Why? Because the production opportunities of each region of the world, each country and indeed each household, has become more diversified. The Detroit of today is not the Detroit of the 1930s, even in Detroit, there are people today who are not dependent on the prosperity of the automobile industry. And in St Gallen, in complete contrast to the situation at the beginning of the twentieth century, only 1.4 percent of the working population is employed in what is today a far less volatile textile sector. The overall result is significantly lower fluctuations in domestic incomes, and also in the growth of GDP.

More consistent growth rates



Source: Russell, Bloomberg, analysis

The greater diversification in the production opportunities of regions, countries and house-holds results not only in lower fluctuations in growth rates, but also in less mutual interdependence. There are neither single "growth engines" nor single "drivers of the global economy". Causalities should not be sought this or the other side of the Atlantic, nor in the Far East; endogenous factors in the regions themselves are likely to be of greater importance. Differences in growth may also be in part simply fortuitous. In any event, it seems to us that far too much attention is devoted to "domino effects" and the like, and the forecasting of corresponding catastrophes. Luckily, the world has become so complex that it's more a case of spellicans than dominoes. Something happens somewhere, and simultaneously causes something else to happen somewhere else – but the pile as a whole remains reasonably stable. Not despite, but on account of its lack of organization.

A global economy?

	USA	Japan	Europe	China	India	Russia
USA	1.00					
Japan	0.45	1.00				
Europe	0.44	0.07	1.00			
China	-0.03	0.63	-0.48	1.00		
India	0.11	0.31	-0.44	0.54	1.00	
Russia	-0.08	0.23	-0.08	-0.12	-0.08	1.00

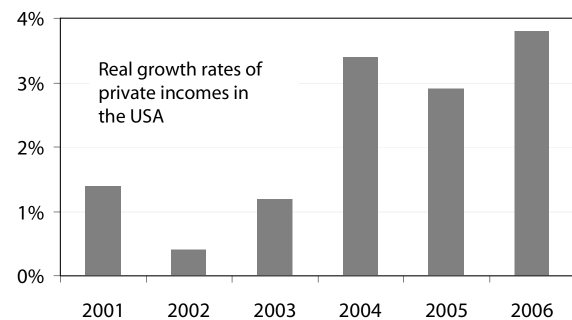
Note: Correlation coefficients of real growth rates 1995-2006; the average of the correlation coefficients is 0.10; for this table, Europe comprises Spain, the United Kingdom, Ireland, Germany, France, Denmark and Italy.

Source: World Bank, US Federal Reserve

It would of course be wrong to underestimate the negative impact of a consumer crisis in the USA, for the satisfactory profits of many companies – and by no means only American ones – rest in part on demand from across the Atlantic. Nor should it be overlooked that the private real estate sector ("residential investment spending") is not only an important component of overall US GDP, at around 4 percent, but that many jobs (8 percent) also depend on it thriving. We do however attach a good deal more weight to the question of whether, and on what scale, building will continue in the USA, than to the question of what effect falling house prices will have on consumer behavior. For where this results in private bankruptcies due to excessive mortgages, it will probably be the financial system, not the debtor, that carries the blow (a state of affairs that the stock markets have probably already discounted in the credit market crisis). And where debt has remained at a reasonable level, the result will simply be to set a limit to the possibility of "wealth extraction" – that is, consumption funded by additional mortgage debt.

The impact of assets on economic growth should not be overestimated, nor the impact of income underestimated. Americans' real income has risen considerably in recent years, as is clearly shown in the figure below.

Americans are earning significantly more



Source: Bureau of Economic Analysis (BEA), analysis

Despite warranted skepticism concerning the relatively widespread, confidence undermining behavior on part of Americans – high levels of personal debt, low levels of savings, enthusiastic consumption – positive, compensating factors should not be simply omitted from the equation. In particular, the stimulating effect of the low dollar on American exports should not be over-looked. America is probably more stable than many think and some would like to believe. We therefore continue to incline towards a "soft landing" for the US economy, and expect the indicators to be pointing upwards again in 2008. In any case, the tremendous resistance shown by the stock exchanges during the credit market crisis is only explicable on the assumption of such a relatively benign scenario. Perhaps the markets are deceiving themselves. Or perhaps it is more likely that the notorious prophets of doom have got it wrong.

5. The credit market crisis – a different perspective

We are well known to be among those who warned against excessively low risk premiums, and the overly casual provision of credit that they gave rise to, together with far too high levels of debt within the financial system. We have identified the reason for this undesirable development in the

continually repeated rescue missions for bankrupt players in the financial system. But we have also pointed to the serious implications that would result if these rescue missions were not undertaken, for the increasing risk of a systemic collapse in financial markets. We will not consider the theoretical alternatives to "bailing out" here. In the meantime, a couple of new facts have arisen in respect to the rescue missions for the German banks IKB and Landesbank Sachsen and the comparatively clumsy emergency help for Northern Rock from the Bank of England. When savers are forming queues at the counters even the most doctrinaire central bank weakens.

It is now clear that the resilience of the credit market over the past months can be attributed to the more or less successful interventions by the central banks. The above-mentioned opening of the discount window by the Fed in the face of the threatened collapse of Countrywide Financial may be regarded as one of the most spectacular and extremely well targeted moves with direct causal impact in the history of the financial system.

But this explains at best a small part of the story. In our view, it is much more interesting to consider whether and to what extent the financial system has functioned during the crisis, and what conclusions can be drawn from this. Given that there were problems in certain areas – and it was clear that there were: excessive, non-repayable debts in the American mortgage sector, excessive leverage in private equity deals and uncertainty about the creditworthiness of many financial instruments and the banks issuing them – the question is, how efficiently did the system deal with these accumulating issues?

If we see things correctly, today we can speak of an amazingly successful operation. For firstly, all the parties involved were obliged, within a very short period, to determine, review and, if necessary, revalue their positions. Secondly, again within a very short period, the whole world was reminded to look at, and treat, risks for what they are, and to abandon the illusory assumption of risk-free profits. Crisis means clarification. That clarification was required is one thing, that this clarification was achieved within a few weeks and is now moving towards its conclusion is quite remarkable. It is cause for encouragement. For it cannot be ruled out that such – potentially gigantic – problems will not recur in the future. It is therefore extremely important that the system can deal with such problems.

But thirdly, what seems most important to us is the fact that overall, little collateral damage has been incurred. The sausage-makers have, so to speak, been left to their own devices, the butchers affected little and the greengrocers not at all. That too is cause for encouragement. For it means that the financial system may well be better able than has been thought to disaggregate individual risks and risk categories, and that the correlation between the individual risk categories is lower overall, even in a crisis. Diversification would then not only make sense as a theoretical concept, but demonstrate highly practical, concrete advantages. The concept of diversification came under pressure in the period from 2001 to 2003, as almost everything lost value, in total correlation, so to speak, only then to regain value fairly simultaneously in the following years. But if in 2007 an enormous partial problem in a part of the market can be resolved without affecting the market as a whole, then perhaps, or hopefully, we are seeing the beginning of a new regime of differentiated problem resolution by the markets.

And if that were so, this would give impetus to all the methods of wealth management based on the concept of diversification: investments oriented on long-term balanced strategic asset allocation, a relatively narrow tactical bandwidth for deviations from these strategic values, a careful approach to the maintenance of (highly diversified) core investments and caution with regard to momentarily 'exciting-looking' investment concepts. Crisis means clarification. If a couple of fundamental economic principles have been revalidated, then this clarification will have been highly beneficial.

6. Clarification needed, for example at UBS AG

This aspect of the credit market crisis – undoubtedly positive from a long-term, higher-order perspective – should of course not distract us from either the 'problem pieces' that remain; the left-over rotten meat, so to speak, or from the continuing threat of contamination from problem positions that have not been resolved, or at least fail to show enhanced transparency. The ice remains exceedingly thin. Confidence is easily lost and the central banks' room for maneuver for other rescue missions has not magically increased. So it is too soon for a general all-clear. Accordingly, our bank stands by its general recommendation of caution with regard to any additional engagement in stocks, however attractive deals may well be worth consideration.

The following considerations about the future of the two big Swiss banks – in this specific case UBS AG – also belong in this speculative category. As we know, in announcing its results for the third quarter of 2007, the bank disclosed a write-off of some CHF 4 billion. This valuation loss came from the investment banking unit, and mainly concerned American sub-prime mortgages inherited from the Dillon Read Hedge fund DRCM, as

well as American mortgage positions taken straight on to the balance sheet. UBS's total engagement in this area amounts to USD 19 billion. Tangentially, so to speak, reserves of a "mere" 300 million had also to be set aside for pending LBO transactions – positions which in total amount to USD 13 billion.

The announcement of such serious involvement by a big Swiss bank in the whole credit market problem came as a shock, not least as it also involved major consequences for its personnel: the dismissal of 1,500 staff, mainly in America, and a change of guard at the top-management level. Interestingly, and not entirely illogically, the stock market took a thoroughly benign view of the announcement. For however negatively the whole business must naturally appear, it was no less positive for market players that clarity had been created on an issue that had been smoldering since the resignation of Peter Wuffli as CEO of UBS in spring 2007. The risk discount for the suspected smoldering was no longer needed – UBS stock rose by 3 percent on the day of the announcement, to CHF 64.50 and there was never any question that UBS, with its revenue situation and reserves, could not carry the blow.

But the stock could have risen far higher. UBS stock has long suffered under an extremely low valuation, when its P/E ratio is taken into account. At currently just on 10, UBS is at the bottom end of the sector, and would in principle be a takeover candidate, even if this would be no easy task, given its high market capitalization (around CHF 140 billion). From a shareholder perspective (which, as wealth managers we are obliged to take), the situation is extremely unsatisfactory, and should be urgently occupying the attention of the UBS board. This, not least because the losses incurred, the consequences for the personnel and UBS's low valuation are causally linked, and ultimately relate to a long standing strategic deficit. The responsibility for strategy, and for deficits, clearly lies with the board of directors. The UBS chairman's remarks on this topic were both long delayed and wholly inadequate.

For one thing is clear: the low valuation of UBS stock is the direct consequence of its engagement in investment banking. The stock exchange generally affords investment banks a low valuation; the median P/E ratio for comparable firms, such as Lehman Brothers, Morgan Stanley, Merrill Lynch or Goldman Sachs has been between 11 and 16 for the last few years. Currently, as a result of the credit market crisis, they all have a P/E ratio of 10. As does UBS.

UBS, however, is not just an investment bank, but also has two other, very important areas of activity, wealth management and commercial banking (Wealth Management & Business Banking WMBB) and global asset management (GAM). Comparable firms operating in these areas have far higher P/E ratios. Wealth managers seem to be particularly popular with the public: their median P/E ratio is around 20 and global asset managers achieve P/E ratios of around 16.

Put differently, investment banking is "poisoning" UBS's valuation to a considerable degree. If UBS's three divisions of wealth management, global asset management and investment banking were valued separately, with P/E ratios typical for these areas of activity – if, as an intellectual exercise, so to speak, three UBS sub-firms were set up, and the costs of the corporate center allocated to them, the UBS stock price would be some 30 percent higher than it now is. In other words, it would pay to break up this giant conglomerate, and give it its freedom on the financial markets as two or three separate firms. This also applies of course, with a grain of salt, for other giant conglomerates, such as Citigroup or – indeed – the other big Swiss bank, Credit Suisse. This raises a much more general question: why on earth do the markets allow such inefficient constructs to continue to exist? Why do the notorious locusts shy away from breaking up such conglomerates? Is sheer scale a protection against such maneuvers?

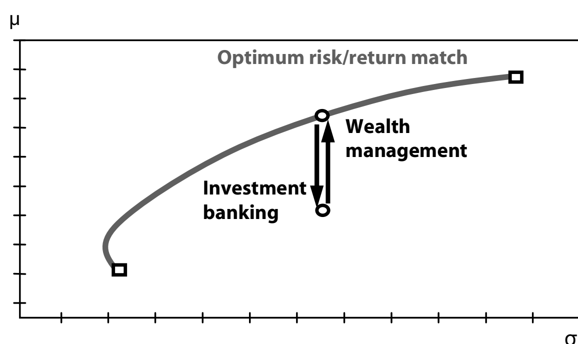
Breaking them up is not really a new idea, and is always opposed with the argument of the high synergies between investment banking, global asset management and wealth management for individuals. This is coupled with the accusation that the break-up idea is based solely on shareholder value considerations, whereas corporate strategy must meet longer-term criteria. We have serious doubts about the validity of this argument. Firstly, it reflects an often stated, but entirely unproven assumption that the shareholder value perspective is exclusively a short-term one. It is far more likely that the management and the board are taking refuge behind "long-term interest" so as not to have to disclose their own interests and their tastes for high office. Secondly, the evidence speaks not for, but against the synergy argument. The dilution of UBS's P/E ratio by its investment banking is a fact, and so is the write-off of CHF 4 billion. A UBS wealth management bank free of investment banking would both have a higher valuation and also be free of problems relating to rotten meat.

Thirdly, the argument fails to understand the real nature of investment banking and wealth management. For their business models are antithetic. Wealth management strives, on the basis of a client mandate, to steer investments as close as

possible to an optimum risk/return situation. In competitive conditions, wealth management cannot permit itself significant deviations from this target. It is therefore typically a service performed on the basis of a mandate and for a commission related to the service provided. Revenue from wealth management is subject to little market fluctuation, and, as mentioned above, the stock markets value this activity correspondingly highly. There is nothing more attractive than (relatively) constant cash flows.

Investment banking, by contrast, derives its revenue from the sale of investment products or the provision of capital for companies. This is not very exciting as pure commission-based business. The real economic incentive consists in profiting from the creation of economically sub-optimum products, with inefficient risk/return profiles: to return to the sausage metaphor, flavorless frank-furters or over-spiced 'cevapcici'. This can be done relatively simply, under two conditions: either when there is an appropriate product pipeline to a wealth management pot, and all the incentives in a vertically integrated banking conglomerate are so set that the bland sausages and the fiery kebabs are both swallowed (those would be the "synergies"), or when market players are ready to swallow anything anyway, in the course of one of the recurring periods of hype. These are the times when investment banking generates the most attractive profits, but they are regularly followed by a rotten-meat crisis, for in the course of the hype not enough attention is paid to economically efficient risk/return matching.

Opposite incentives



Note: μ = expected annual return; σ = standard deviation of expected annual return.

Source: analysis

The synergy argument is thus not merely a weak one, but rather a false one. The two activities are in principle impossible to combine, because they are of opposite nature. Moreover, investment banking exploits the placement power and the (relatively) constant cash flow of the wealth management bank, without delivering an appropriate return for the conglomerate as a whole. Enormously generous bonus schemes mean that a significant part of the economic profit is not passed on, but disappears into the private pockets of the investment bankers. The risk of rotten meat, though, must be borne entirely by the conglomerate, or its shareholders, in the form of a lower P/E ratio. Things could hardly be more asymmetric. The ever recurring management problems that Swiss banks encounter with their units abroad are thus not due to any particular incompetence on the part of Swiss managers when dealing with Americans, but are of fundamental nature. What does not belong together should not be joined together!

7. Crisis as opportunity

If we currently take a significantly more positive view of the (financial) world than was the case a few weeks ago, then this is undoubtedly because we can see that the veil is slowly being lifted from the most acute uncertainties, and that the probability of genuinely serious consequences for economic growth are relatively low. We also recognize the extent to which a crisis can open people's eyes. If we are aware of the mechanisms governing meat, sausages, and the danger of periodic rotten meat scandals, then we know what guidelines we shall need to follow in our future investments. Going further, we may also hope – indeed, speculate – that the bitter experience of high valuation losses on the books of renowned banks might open a good many more eyes, so that action that is overdue from a strategic perspective might be taken. As shareholders we could only welcome such remedial action in the wake of the crisis.

KH, 8.10.2007