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Financial Market Innovation

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Financial Innovation and Risks

Everywhere we see signs of excess liquidity, asset inflation and M&A resulting from (burgeoning) pools of private capital and leverage. Structured products are exploding as a new asset class; fund mangers have more money than they can invest in reasonably valued stocks; private equity firms aren't able to find deals quickly enough to draw down the capital coming their way; and new managed funds in Asia are fully subscribed within days? Innovative financial markets and globalisation facilitate the leverage process and lock onto the cheapest ways to do things. However, excess capital and leverage is usually the result of distortions and accommodating monetary policy somewhere in the world. These distortions aren't innovation, and they bring risks into the global economy. I will illustrate with 4 developments: Private equity, the sub-prime crisis, hedge funds and structured products.

1. Private equity. Some people make the mistake that, because they did not notice it before, then a financial phenomenon in the news must be a 'new innovation'. Private equity is as old as the hills—yet the Trade Union movement in Europe sees it as a newly-arrived evil. What they are really noticing is that it is booming again, as it did in the late 1980s. The reason for the boom is the low global cost of capital, making it cheap to borrow in order to buy currently (or potentially) profitable companies. The most basic cause of the low cost of capital is excess saving in China, Japan and oil producers, together with policies to fix the exchange rate—or in Japan's case to keep it at a low level via their zero-interest-rate policy. The recycling of excess saving balances into the West is a key contributor to low real interest rates, and financial innovation plays a secondary role through the carry trade (implemented with derivatives), etc., leading to inverted yield curves and narrow corporate interest rate spreads. Remember, though, that the last time we had a liquidity-driven LBO boom, it was in the late 80s, when the $ weak and the Louvre Accord was causing large countries to intervene to prevent their currencies from rising—just like China and Japan (through different approaches) right now. It is Economics 101 that you can't fix the price of money and control the quantity of it at the same time. Excess liquidity results in low interest rates and this has opened an enormous arbitrage opportunity for private equity firms to use debt to buy companies, driving equities prices higher. The whole process must be unstable if the cost of capital is too low—that is, it could become a 'bubble' in the end, and these always end badly. So matching innovation with old-fashioned distorting policies of fixing prices like exchange rates and not controlling quantities is risk—it's like a giant patchwork balloon with flexible and inflexible patches—if you keep pumping in the air the tension between flexible and inflexible patches will, in the end, will cause the balloon to burst.

2. Sub-prime crisis. Sub-prime lending was one of the early beneficiaries in the global liquidity bubble that I am talking about. Sub prime lending is a new innovation, where mortgages are offered to low-income high-risk borrowers, and banks and other lenders transfer the risk off their balance sheets by slicing and dicing the principal and income streams into securitised tranches to suit investors seeking yield. Some of the high-yield notes are rubber stamped by credit rating agencies, and end up in yield-hungry pension funds insurance companies and hedge funds. The big benefit is that people who previously could not dream of owning a home share in the benefits of financial innovation. But when rates rise and they can't pay, the end buyer of the high yield notes-having had blind faith in the credit rating agency suddenly ends up with a problem. My view is that a lot of the new players in originating sub-prime will go under, and the industry will move a little back from the too rapid innovation we have seen. Who knows, we may get a little more good-old-fashioned kicking of the tyres again before loans are dished out so freely.

3. Hedge funds. Hedge Funds too have been around for a long time—remember George Soros taking on the Bank of England over sterling targets; well hedge funds had already been around some time by then. Of course they have proliferated since those days and asset under management are around $1.4 trillion in mid 2007. But the leverage hedge funds use alongside of this is much bigger. In my view official estimates are way too low. Leverage could be well over $5trillion, if derivatives are taken properly into account. Once again, low interest rates and low volatility are part of the reason why leverage is so high. Fortunately hedge funds actually play a very positive role in financial markets by buying and selling miss-priced assets, which reduces financial volatility. They also offer alternative investments for pension funds that are very desirable, as they are less correlated with other assets, and perform very well in market downturns (since their style is often one of arbitrage plays, and not betting on the direction of the market). If the global cost of capital were suddenly to rise however, we could expect hedge funds to play a role in rising volatility and the possibility of failures like LTCM crisis. This will not be due to hedge funds being a flawed concept, but rather because the bubble in liquidity went on for too long and leverage became too extreme—the patchwork balloon again.

4. Structured products. The new generation of structured products do fit into the category of new innovations that raise concerns in my view. These include a lot of the CDOs and CLOs we came across in the sub-prime discussion, but they also include new products that are competing with hedge funds for asset classes that meet investor return aspirations, while protecting down-side risk to investor's capital. Constant Proportion Portfolio Insurance (CPPI) products fit into this category, and many providers seem to be making promises to investors akin to letting you bet on the (already-known) winner at the horse races. These products use synthetic option replication techniques. In essence they are passive products—that is, they are program-driven and do not have the benefit of the hedge fund managers skill if something goes wrong. What concerns me about these products is that they are so complex and yet are sold to retail clients with little explanation of the complexity or risks. These products are booming right now, particularly in Europe and Asia, and their popularity is helped by the current cheap pricing of derivatives (helped by the very bubble in liquidity that we have been talking about earlier, which drives down the cost of leverage and reduces volatility). These products have not been tested in a major market downturn, where risky asset prices fall in a ‘gap’ event by say 20-25%. Investment banks, who are often the main providers of structured products, will rely heavily on counterparties being able to meet margin calls in these circumstances—particularly those hedge funds and others selling put protection. These scenarios pose risks to client’s portfolios and/or to the capital and profitability of the providers.

I will stop there. But suffice it to say that so far we have been in the ‘virtuous circle’ of the trends I have been describing. The good times may go on for some time. As we say in investor circles, it will only end badly if goes well for some time yet—that is exactly how bubbles come about.