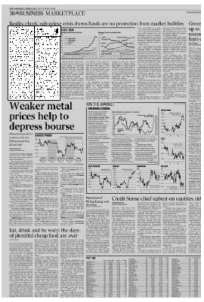

Weekend Australian
Saturday 31/5/2008
Page: 36
Section: Business News
Region: National Circulation: 303,000
Type: National
Size: 440.38 sq.cms.

Reality check: sub-prime crisis shows funds are no protection from market bubbles

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THE high tide of the global credit crisis is slowly receding, leaving behind the financial wreckage that inevitably marks the end of periods of financial excess. And once again we have found that financial markets are much more dangerous places than we like to think, or are led to believe.

Once more the belief in efficient markets and rational investors that has underpinned both theory and practice in these markets has been found wanting. The only surprise, and that a mild one to anybody familiar with human behaviour, is how long beliefs and practices based on demonstrably false premises can persist.

However, this is changing under the pressure of persistent assaults from market events and the findings of new areas of theory, notably behavioural finance. The global credit crunch is only the latest in a series of severe market dislocations that seem to be increasingly common.

Two Australian economists, Christopher Joye and Joshua Gans, have provided a timely discussion of these developments in a recent paper, "Aussie Mac: A policy proposal for Australia".

In standard finance theory, academics and the financial market practioners that follow their prescriptions have all too often have made two erroneous assumption. The first is that asset returns are "normally distributed" — that is, virtually never subject to events like the 1987 share market crash or the 2001 tech wreck.

The second is that financial markets are frictionless — so that investors always benefit from perfectly liquid markets and perfect pricing — or, as economists like to call it, price discovery.

These assumptions, Joye and Gans point out by way of illustration, underpin the Capital Asset Pricing Model (CAPM) that is widely used around the world by investors and their advisers. At least until recently, the assumptions of perfect liquidity and return normality were key features of almost all financial models used by financial market participants.

In the real world, as the current global credit crisis dramatically illustrates, investors are finding they are increasingly confronted by periods of profound market illiquidity and extremely poor market pricing, even complete market failure. The collapse of Australia's Residential Mortgage-backed Securities market is an example.

There have been other examples in the last two decades, such as the collapse of Long-term Capital Management, the huge US hedge fund that employed Noble prize winners to build its financial models. It was brought undone by the Russian government's default on its bonds.

This, and the credit crunch, illustrate that allegedly sophisticated investors are as prone to investment miscalculations as ordinary households, the difference being their mistakes are far more costly, and too often they walk away with a golden handshake, leaving financially shattered investors and shareholders behind them.

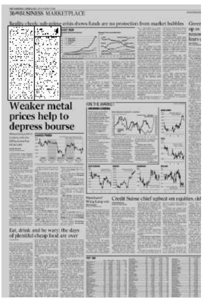
So financial markets are often not efficient in the sense proposed by University of Chicago economists like Eugene Fama. And, Joye and Gans point out that the efficient market paradigm in turn hinged on another assumption by economists — that investors, at least in aggregate, are rational. That is, they are not subject to systematic behavioural biases.

The assumption of rational behaviour has not only underpinned the efficient markets theory but macroeconomic theory more generally.

Behavioural economics and even simple observation of investor behaviour, both individual investors and huge financial institutions, show this is a false assumption. Just read Charles Kindleberger's *Manias, Panics, and Crashes* or John Kenneth Galbraith's *The Great Crash*, to see how irrational investors can be. Yet, so strong are the instincts and drives behind this behaviour, we continue to exhibit it. This irrationality feeds asset price bubbles and crashes.

So what are investors afloat in this sea of risk, uncertainty and human frailties to do?

Problems of severe illiquidity and their consequences are beyond the ability of investors, and often markets, to correct unaided, so we have seen central banks and governments intervening. Intervention has its problems and needs to be carefully managed,



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but it unavoidable in a crisis.

But what about individual investors' risk management? These days, either because they are compelled to do so by compulsory superannuation or because they feel financial markets have become too complex for individual investors, they have turned to managed funds.

The latest figures for funds under management from the Australian Bureau of Statistics this week are shown in the charts, along with asset allocation. They show the extraordinary growth of superannuation and the recent decline, which has had punters anxiously consulting their computer screens to track the decline in the value of their portfolios.

Funds are no protection from market bubbles, and the author of these charts, Gerard Minack from Morgan Stanley, is quite critical of their heavy exposure to domestic equities. Minack is a big bear, but his concerns seem warranted.

If the Reserve Bank succeeds in slowing the economy in accord with its latest forecasts, it is hard to believe corporate profits and hence equity prices won't be adversely affected. And, as Minack points out, both cash (bank deposits) and bonds are attractive alternatives.

Fund managers are subject to herding and other irrational behaviour too. And fund investors are exposed to the risk of disguised risk-taking, and excessive fees whether their fund balances are rising or falling.

Ironically, plain vanilla index share funds like Vanguard, which promise to match the overall stock market, are actually the outgrowth of the efficient markets theory. But there is ample evidence to suggest that, over the medium to long term, they are still the best place for unsophisticated investors.

Fund managers who offer more active management and diversified asset portfolios have generally underperformed index funds over time. Given the increased risk being transferred to households via superannuation, investor education and commercially impartial advice are also necessary.

Last night, Superannuation Minister Nick Sherry and Finance Minister Lindsay Tanner released a consultation paper on superannuation advice from the Financial Services Working Group — a joint initiative of Treasury, Finance and ASIC — which sounds like a step in the right direction. It is looking at key issues related to financial disclosure and advice.

But human behaviour, however "irrational.', is remarkably persistent.