Lessons from the 2007 disaster

SHOULD WISE INVESTORS SWITCH OUT OF FINANCIAL ASSETS AS A RESULT OF THE CRISIS IN THE EUROZONE? ASK CHIN-BUN TSE AND TIMOTHY RODGERS

The ongoing euro crisis is prompting investors to evaluate their investment portfolios and consider repositioning their investment strategies. In this article, we examine the lessons that European investors can learn from the global meltdown that began in 2007 and eventually brought many Western financial institutions to their knees.

The 2007 crisis has been portrayed in many quarters as an Anglo-Saxon crisis, and indeed the impact was a lot more severe in the UK than in euro-area countries. But as the euro crisis unfolds, its impact is being felt acutely across the whole of the continent. We therefore believe that all European investors would be wise to take heed of the lessons learnt from the previous experiences of UK-based investors.

The UK monetary authorities were initially slow to respond to the unfolding disaster of 2007. It wasn't until December 2007 that the Bank of England started to cut the base rate, which was eventually slashed to a historical low of 0.5% in March 2009. Observers of the euro crisis should note that the responses of governments and monetary authorities across the world failed to prevent the crisis culminating in the bankruptcy of Lehman Brothers in September 2008 and the subsequent need to bail out numerous financial institutions across the world. Given that governments appeared to have been effectively powerless to protect financial markets, what should the wise investor have done? Here, we show that, in hindsight, we can see that they should have switched their portfolio away from traditional financial securities towards more tangible assets, such as commodities and gold. We believe that parallels between the current euro crisis and the 2007 crisis mean there are potential lessons from which *all* investors can learn.

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Lessons from history: asset class switching

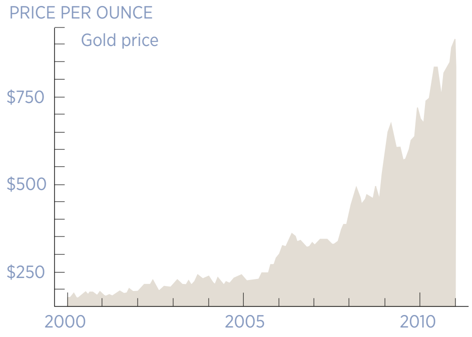
Lessons from history are often a good starting point for making investment decisions. Stock market crises and stock market cycles are nothing new; since the Great Depression of the 1930s, there have been more than 20 full cycles in the UK market. A key lesson we can learn from these previous experiences is that after severe shocks investors often respond with a considerable amount of switching between asset classes. For example, during the slump of 1973/74, which resulted in the London market falling by around 73%, there was a significant switch out of stocks and into commodities. As stock prices fell, commodity prices rose. This resulted in the CRB commodities index more than doubling between 1972 and 1974. A significant amount of asset class switching also occurred in response to the stock market crash of 1987. In response to the severity of the shock they experienced, many pension funds switched considerable proportions of their portfolios out of stocks and into what they saw to be safer bonds.

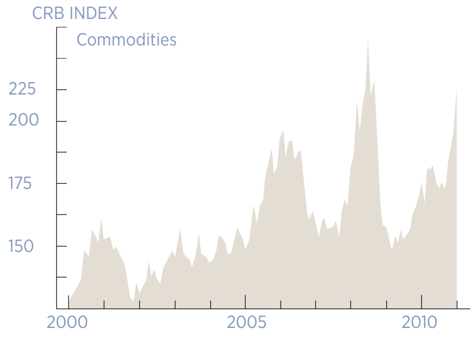
Asset class performances before and after the 2007 crisis

The lessons from history suggest that crisis will encourage asset class switching. But is this the rational behaviour of an investor looking to maximise returns or simply panic buying/selling? To answer this question, we need to examine what happened to returns across different asset classes in response to the 2007 crisis. As the crisis developed towards the end of 2007, UK equity returns began to show sharp increases in volatility as the bear market developed momentum. Volatility was high throughout much of 2008 and culminated in negative returns of -14.5%[1] during September 2008. This did not, however, mark the point of market capitulation as it preceded the market low point by almost six months.

Bonds and gold are often seen as safe havens during times of crisis by investors looking to move their assets into less risky asset classes. Although the bond market as a whole showed considerably less volatility than other markets, a flight to risk-free government bonds was partly offset by a movement out of corporate bonds. As a result, volatility was relatively high by historical standards across the bond market as a whole; monthly returns of sterling bonds fluctuated between +4% and -4% towards the end of 2008[2]. The financial crisis also saw the demand for gold increase considerably. Prices started to show significant increases from September 2007, with volatility peaking at roughly the same time as equities and culminating, in late 2008, in monthly returns reaching 16.2%.

During crisis periods investors often show more faith in physically tangible assets. We can ask the question of whether, as a consequence, non-financial assets perform





Asset	Jan 2000 to Jul 2007		Aug 2007 to Dec 2010	
	Mean monthly return	Standard deviation	Mean monthly return	Standard deviation
Shares	0.295	3.722	0.005	5.570
Bonds	0.448	1.196	0.463*	1.827*
Goods	0.253	3.477	0.409	5.580
Gold	0.695	3.736	2.423	6.119
Housing	0.925	0.468	-0.031	1.001

*Data to December 2009

Graphs 1 and 2 (above) Prices for gold and commodities 2000-2011[3]
Table 1 (above right) Monthly mean returns in £ sterling before and after the start of the financial crisis

better during these periods. The performance of gold can be contrasted with that of general commodities. As the graphs above show, gold prices rose aggressively during this period while, initially at least, commodities saw large falls with negative monthly returns as high as almost -15% towards the end of 2008. This fall was in response to the perceived threat of a global slowdown developing in response to the financial crisis. Once this threat receded, however, commodity prices subsequently resumed their upward trend.

In contrast to the other asset classes, the UK residential housing market was initially a relative oasis of calm during the early period of financial market volatility. But after a considerable lag, the financial crisis has had a significant negative impact on prices. By the end of 2008, monthly returns saw their biggest falls of approximately -2%. The low point in prices was not reached until the middle of 2009, however. This was significantly later than the low point for most of the other asset classes.

Should the wise investor have switched out of financial assets?

Our analysis shows different sectors responded in different ways and with different speeds to the 2007 crisis; consequently, making the correct investment choices during this period was not easy. The table above shows that immediately prior to the crisis, housing produced the highest average returns for UK investors, but, in the post-crisis period, this switched to gold. What is also clear is that the relative performance of different asset classes changed considerably. So in answer to the question we pose in this article, we would say, yes, wise investors should indeed have considered switching from financial assets to gold, and possibly also commodities, to obtain higher returns.

Will history repeat itself with the euro crisis?

Can the experience of the out-performance of gold and commodities in response to the 2007 crisis provide useful investment insights for investors looking to protect their returns from the current financial storm? This question is not so easy to answer as no two crises develop in the same way. Recently, we have seen that, as the threat of financial contagion spreads, German bunds rather than gold appear to have become the favoured safe haven asset and at the same time commodities have lost their appeal as worries about a ‘hard landing’ in China grow. Other non-financial asset prices, such as real estate, have also fallen by significant amounts across a number of European countries.

History shows that in times of crisis a considerable amount of asset class switching arises and this, rather than knowledge of which asset classes outperformed, is probably the most important lesson that the wise investor can take from the 2007 crisis.

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[1] RETURNS ARE ESTIMATED USING LOGARITHMIC RATES USING THE MSCI UK TOTAL RETURNS INDEX
[2] SOURCE: BARCLAYS CAPITAL STERLING BOND INDEX
[3] SOURCES: THOMSON REUTERS/JEFFERIES INDEX CRB INDEX AND THE LONDON BULLION MARKET ASSOCIATION