SUMMER 2014

INVESTMENT OUTLOOK

Lessons Learned from the Great Financial Crisis

Six years ago this September, a 158-year-old banking franchise went bankrupt. As we approach the anniversary of the collapse of Lehman Brothers and the global financial market panic that followed, we thought it was a good time to reflect on lessons learned from that period.

> "… rarely does the same problem create the next crisis."

In some ways, the market has fundamentally changed, not unlike after the Great Depression of the 1930's where a whole generation became frightened of investing in stock markets. However, against this backdrop of investor sentiment, North American stock markets have recently been setting record highs and credit markets have been reaching record low yields.

In financial markets, rarely does the same problem create the next crisis. So while the US Federal Reserve (the Fed) and governments around the world have taken strong steps towards preventing another 2008 crisis, the unintended consequence of these steps is they may contribute to different problems in the future.

For one, the Fed stimulus money has pushed bond yields to their lowest point in 75 years. This has driven investors to seek income from a variety of 'bond-surrogate' investments, such as: high dividend paying stocks, high yield bonds, levered loans, and real estate. The proliferation of these products and strategies have introduced different risks to investors, including liquidity, valuation, and regulatory changes. Secondly, governments have introduced much tougher capital rules on US and International banks to reduce the chance of future bank failures like Lehman Brothers. This has led banks to use far less of their own capital in global markets, which in turn, has reduced secondary market liquidity for many of these securities and removed some of the more credit-worthy bank counterparties in these markets.

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Given these observations, what lessons have we learned that we can apply when investing on behalf of our clients in the future?

1) Apply healthy skepticism to the next new product or approach in investing. The crisis in 2008 was presaged by a record set of innovations in credit markets. Sub-prime asset-backed securities, collateralized debt obligations and increased leverage magnified what might have been a contained real estate correction to a broader financial collapse. Today, we are seeing many new 'alternative' strategies, asset classes and products, which all come with their own set of risks.

2) Plan ahead so you are not forced to sell at times when the market's liquidity dries up. The inability to effectively transact due to illiquidity in financial markets was one of the key accelerants of the financial crisis. Market participants were forced to sell securities at fire sale prices for a variety of reasons. Often when you are forced to sell, you must let go of the good assets, not the ones you would prefer to sell. The key protection from illiquidity is to focus on owning high quality investments and effective diversification. We continue to believe a balanced portfolio of high quality fixed income investments combined with appropriately priced stocks is the most effective means of building and protecting wealth over the long run.

3) Be aware of the impact of debt levels. In 2008, high levels of debt or leverage adversely impacted markets. This could be seen economy-wide as consumers struggled under the burden of increased mortgage and consumer debt. It could also be seen on a company-by-company basis as management struggled to restructure under tighter credit conditions. Leith Wheeler has always believed that investments need to demonstrate an appropriate level of financial conservatism and manageable debt levels to meet our investment criteria. We continue to look for these high quality investments today.

4) Remember that markets will recover. If your financial plan is adequate and you don't NEED to sell, don't panic and sell securities when the outlook seems bleak. This is when successful investors are buying, not selling.

The worst financial crisis since the Great Depression, while painful, helped to validate the investment approach we have applied at Leith Wheeler over the past 30 years. That said, we have seen some structural changes in investor sentiment over the past several years. In previous investment cycles, we would expect to see much more investor hubris and overconfidence as we approach and exceed record highs. Today, investor surveys show that people are quite skeptical of the market's increase. Investors seem to be looking over their shoulder for what could come up next. Over the last several years, multiple areas of financial market concern have been labeled the "Next Lehman". Whether it's concern over potential economic slowing in China, the bankruptcy of Greece or high government debt levels in the US, it's important to keep in mind that the US went close to 80 years between the Great Depression and the financial crisis in 2008. It's unlikely the next Lehman will occur until the current set of market participants have fully forgotten about the last Lehman. Furthermore, it is unlikely the next crisis will be triggered by any event investors see coming or could accurately predict. The reason crises can have such a significant impact is because they are surprises.

So what are the warnings signs for potential problems?

- Look at stock market valuations. They have definitely Increased over the last several years but in general, market levels have been supported by lower interest rates and Improving earnings.
- Watch for signs of investor mania or failure to appreciate Investment risk. Today, most investors are preoccupied with what could go wrong, rather than filled with overconfidence In the markets. However, as we mentioned above, the number of new bond-surrogate-type products can be concerning.

Conclusion

The 2008 crisis should teach us to embrace investment strategies that stand the test of time. While we need to be vigilant for the warning signs that presage future challenges, we do not want to miss current opportunities by focusing on painful memories of the previous crisis. The performance of equity markets in the 1930's scarred an entire generation of investors. They held on to term deposits and fixed income investments while missing out on the strong performance in equity markets through the 1950's and 60's. So heed lessons learned to create a portfolio that can withstand tough markets, respect the past and be open to the opportunities of the future.

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