CAN FINANCIAL INNOVATION TURN SOUR

Over the past several years, financial innovation has become a constant theme. Variously known as swaps, derivatives, structured notes or asset backed securities, special purpose securities have been created to manage risks, provide liquidity, change the term structure of balance sheets – almost any purpose that creative financial people could conceive. There are few corporations that have not availed themselves of some of these highly useful securities. The market for these instruments has become incomprehensibly huge – by some estimates in excess of $100 trillion.
Individually, and in the hands of capable and honest financial officers, these instruments serve important financial functions, principally to change the shape of the balance sheet and manage cash flows in a very cost-effective manner. As Mr. Greenspan constantly assures his listeners, moving risks from organizations that do not want it to those that do, adds to the productivity of the nation. [These markets of course are extremely global, but the principles apply universally.] Sometimes, it is hard to remember that risks are simply being moved around the playing surface – a surface that is seldom level.

Collectively, there are grounds for concern. Many of these instruments depend on highly liquid markets for their effectiveness. For example, many of those who accept the higher risks [to gain a higher return] assume that they will be able to get rid of an offending instrument if it turns sour, and in fact may sell it short to profit from the decline. A key factor in the demise of Long Term Capital Management was a process that Mr. Greenspan calls “disengagement”. Markets have a nasty habit of refusing to bid on securities in distress, and exit strategies may fail.

A second concern is that many specialized organizations have developed to invest in riskier products. Hedge funds and mutual funds have, in many instances, become repositories into which investors place their assets [and their trust], relying on the sophistication and expertise of investment managers who promise returns far greater than uninstructed people can create for themselves. In many instances, these organizations can enhance returns by borrowing funds to compound the magic of their expertise. In May, 2002, a promising new type of debt security was created. Two managers of hedge fund managers issued debt of $750 million US to invest in a portfolio of hedge fund strategies. If this is too complicated, interested readers might profit by reading the chapter entitled “In Goldman Sachs We Trust” in John Kenneth Galbraith’s The Great Crash.

A third concern is that many investors [carrying the risks laid off] are crowded into the same trade, which is to say, have placed the same bets. If someone in the theatre should shout fire, the exit doors may prove to be far too narrow.

One way or another, these specialized securities have been implicated in most of the financial disasters of the 1990s – Orange County, Barings, Metallgeschaft, Long Term Capital – and the market has continued to grow exponentially. We are keeping a vigilant eye open, hoping that our concerns are misplaced.