No Current Need to Parse the Chairman

Alan Greenspan deserves his reputation for indirect and opaque commentary. Economists have long been accused of hedging their analysis with incomprehensible jargon. In his years as the Federal Reserve Chairman, he has elevated his economic and market commentary to the point that even he might not understand the intent of his remarks. This has not always been the case with Mr. Greenspan. In a 1967 essay he argued that in the absence of a gold standard that there was “no way to protect savings from confiscation through inflation.” The modern Chairman Greenspan has presided over unprecedented monetary stimulation. The effects of this paper money bonanza are now starting to concern him. In a marked departure from his normally opaque commentary, Mr. Greenspan’s speech to an International Monetary Conference in Beijing should be a prescient warning to those investors joining the rush into “alternative investments”. In his words:

“Consequently, after its recent very rapid advance, the hedge fund industry could temporarily shrink, and many wealthy fund managers and investors could become less wealthy.”
-Alan Greenspan, Chairman, Federal Reserve Board

Chairman Greenspan of the US Federal Reserve is not always difficult to understand. In 1967, he published an essay, entitled Gold and Economic Freedom. In that essay, he argued: “In the absence of the gold standard, there is no way to protect savings from confiscation through inflation.” Recall the context. The Vietnam War was escalating and President Johnson pursuing a “Guns and Butter” fiscal policy. Monetary policy was called upon to support the nation’s objectives. Foreign central banks began demanding the conversion of US paper into the gold held in Fort Knox. Only four years later, President Nixon was forced to end the charade of dollar convertibility into gold (an untrue gold standard), and the Stagflation Era began. As Greenspan had predicted, the savings of the post-war generation was savaged over the next fifteen years.

In his years as the Federal Reserve Chairman, Greenspan felt the need to speak so opaquely that it became necessary to parse his every utterance – teasing meaning and implication from tea-leaves carefully hidden between the lines. Our archives contain two attempts to do that. It is now a commonplace that he “speaks in tongues.” Beginning in 1990, the US financial system has been beset by a series of financial challenges that threatened the confidence so fundamental to financial and economic stability. (Think: real estate meltdown of 1990 and the erosion of bank equity, Orange County bankrupted by mortgage security misunderstandings, threatened Mexican insolvency in 1995, the implosion of Long Term Capital Management in 1998, the technology meltdowns of 2001, Ford Motor Credit at the wall in October 2002, etc.)

In this environment, soothing words were required to maintain confidence, and the Chairman delivered. The words worked because they were accompanied by lots of credit, initially banking system and latterly, mortgage market ease of unprecedented magnitude. And the soothing words made only oblique and veiled reference to the underlying challenges.

In late 2003 the situation changed, and the crisis of October 2002 had been successfully managed. Short term interest rates (pushed abruptly down to 1%) had worked their magic, and were then unsustainably low. The soothing words announced a “measured” pace of interest rate increases in prospect, and in eight gentle steps the Federal Funds Rate has been raised from 1% to 3% as of June, 2005. Financial commentators now opine as to whether or not the measured process is complete, nearing its end or still in its early stages. Time will tell, but we don’t think it is the crucial issue, and nor does the Chairman.

Reverting back to his 1967 form, Greenspan is telling us bluntly that there are other bigger issues to confront. For those lulled by the soothing words of the past fifteen years, a speech he made to an International Monetary Conference in Beijing on June 6, the following paragraphs should be a shocking wakeup call.

> “Whatever the underlying causes, low risk-free long-term rates worldwide seem to be one factor driving investors to reach for higher returns, thereby lowering the compensation for bearing credit risk and many other financial risks over recent years. The search for yield is particularly manifest in the massive inflows of funds to private equity firms and hedge funds. These entities have been able to raise significant resources from investors who are apparently seeking above-average risk-adjusted rates of return, which, of course, can be achieved by only a minority of investors. To meet this demand, hedge fund managers are devising increasingly more complex trading strategies to exploit perceived arbitrage opportunities, which are judged–in many cases erroneously–to offer excess rates of return. This effort is particularly evident in the pronounced growth and increasing complexity of collateralized debt obligations. Although collateralized debt obligations are a powerful tool for enhancing risk management by separating idiosyncratic risks from systematic risks, the models used to price and hedge these instruments are just beginning to be tested.
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> I have no doubt that many of the new hedge fund entrepreneurs are embracing a strategy of pinpointing temporary market inefficiencies, the exploitation of which is expected to yield above-average rates of return. For the time being, most of the low-hanging fruit of readily available profits has already been picked by the managers of the massive influx of hedge fund capital, leaving as a byproduct much-more-efficient markets and normal returns.
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> But continuing efforts to seek above-average returns could create risks for which compensation is inadequate. Significant numbers of trading strategies are already destined to prove disappointing, a point that recent data on the distribution of hedge fund returns seem to be confirming.
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> Consequently, after its recent very rapid advance, the hedge fund industry could temporarily shrink, and many wealthy fund managers and investors could become less wealthy. But so long as banks and other lenders to these ventures are managing their credit risks effectively, this necessary adjustment should not pose a threat to financial stability.
> I trust such an episode would not induce us to lose sight of the very important contributions hedge funds and new financial products have made to financial stability by increasing market liquidity and spreading financial risk, and thereby enhancing economic flexibility and resilience.”

As Chairman, Greenspan has never been so forthright. We believe he places high probabilities on the following, just as he did when he correctly anticipated the pressures to abandon the Bretton-Woods Agreements and the inflationary aftermath:

1. Expectations of high returns on money placed with hedge funds are likely to be disappointed. 8,000 hedge funds, controlling $1 trillion, expect to earn above average returns, “rates of return, which, of course, can be achieved by only a minority of investors” since the “low-hanging fruit of readily available profits has already been picked”. Hedge fund managers and the brokers and banks that service them offer “increasingly more complex trading strategies to exploit perceived arbitrage opportunities, which are judged–in many cases erroneously–to offer excess rates of return”.

2. There is an inevitable and even ‘necessary’ outcome: a market shrinking process during which “many wealthy fund managers and investors could become less wealthy”. This in itself is not a difficulty for Greenspan since one tenet of Fed dogma is that risks have been shifted to those who are knowledgeable and can afford to take them. Unfortunately, few investors have the time, resources and expertise to understand these highly complex structures, and rely on the rating agencies, themselves lacking in time, resources and expertise, but also paid by the originators of these structured products. The Chairman does not address the major problem that hedge fund investors are increasingly pension, insurance and mutual funds driven by the search for income to take incomprehensible risks.

3. No one knows how these vehicles are going to perform under adverse circumstances. The challenge of delivering unattainable results (necessary to justify substantial fees) has created “pronounced growth and increasing complexity of collateralized debt obligations”, and the complex models “used to price and hedge these instruments are just beginning to be tested.” One lesson of the Long Term Capital meltdown is that complex models can break down.

4. He leaves us with an enormous question, stated as a fact: “so long as banks and other lenders to these ventures are managing their credit risks effectively, this necessary adjustment should not pose a threat to financial stability”. Greenspan has spent the last fifteen years picking up the pieces of banks and lenders that did not manage their credit risks appropriately. Is it likely that he actually has that confidence now – at a time when investor thirst for return rages, deal complexity escalates and lending standards diminished?

The words and the delivery still sooth. This speech was delivered in Beijing, and therefore was less reported than his remarks to Congress. But Greenspan is posing a real question that should trouble all investors: Has the combination of investor stretch for returns, naïve confidence in financial experts and sophisticated packaging of financial stuff created important systemic risks? The next four years will be fascinating.

This article is the latest in a series on Federal Reserve policy by Bob Swan. Bob is a Vice President and Portfolio Manager at Canso. Bob has many years of experience in investment strategy and provides considerable insight into the financial markets.

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