

Perspectives on Recent Market Volatility

What is going on here?

On July 19th, 2007, the Dow Jones Industrial Average closed above 14,000—an all-time record high. Since that date, the global markets and all asset classes—fixed income, US equities, international and emerging markets equities, and real estate—have been rocked with volatility, mostly on the downside. For many of our clients, this is their first choppy market. For others, it has been a long time since markets were so uncertain. Even those who accept intellectually that returns could be negative, they may be having emotional difficulty dealing with the reality of the day-to-day or even intraday price movements.

What to do?

In view of the long-term investment approach we advocate, we *do not* recommend changing course and succumbing to the negative psychology of a difficult and uncertain market, despite the level of discomfort that we all are feeling. We believe that individual risk tolerance is relatively stable although the perceptions of risk can change in an instant. It is important to realize that market conditions reflect the views of active participants. Those who are following a buy-hold-rebalance strategy do not influence market directions except when they are making new investments or rebalancing existing holdings. The key is to focus on the long-term benefits of our investment approach and avoid getting caught up on the daily media bandwagon or falling prey to the “Chicken Little” syndrome.

What are others saying?

To provide a broader perspective on recent market volatility, the following quotes reflect a wide range of views expressed by a representative group of opinion leaders in the financial industry. Our intent is to provide additional context for the challenging market conditions we are currently experiencing.

“While we are unmistakably experiencing volatility in our financial markets, global economic fundamentals remain healthy. That provides a solid base for financial markets to continue to adjust. The lesson here is not new--in a long period of economic expansion and benign markets, there is a temptation to give way to excesses. This has been a wake-up call. It's a reminder that all participants need to completely understand the risks they take and be vigilant.”

Henry M. Paulson, Secretary of the Treasury of the United States

“To make money, at least in the postwar world, all you have to do is buy the broad indexes domestically--both in the emerging world and in the developed world--and, to throw in a little certainty about your old age, maybe buy some annuities. To lose money, pretend you're really, really clever, and that by reading financial journalism and watching CNBC, you can outguess the market day by day. Along with that, you must have absolutely no sense of proportion about money and the world at large. The real story is that long-term investors who have some sense of proportion make money. Short-term investors who live and die by the sweep-second hand of the \$300,000 watch get rich fast and poor fast and sometimes are slaughtered faster. For the rest of us, the stock market is cheap on a price-earnings basis, profits are fabulous, Mrs. Clinton and Mr. Giuliani are far from being socialists and in the long run, both here and abroad, stocks are a lovely place to be. I have no idea what the S&P will be ten days from now, but I am confident it will be a lot higher ten years from now, and for most Americans, that's what we need to think about. The subprime and private equity and hedge fund dogs may bark, but the stock market caravan moves on.”

Ben Stein, Economist, writer, lawyer, and actor

“Liquidity is not about physical cash; it is mainly a psychological state. Subprime problems have consumed only trivial amounts of global cash but already have burst bubbles by shocking lenders. Total losses will probably be less than 1% of household wealth and only 2% to 3% of one year's GDP, so this is not Armageddon.”

Wilbur Ross, Chairman and CEO, WL Ross & Co.

“It's not all bad news now. There's still liquidity in the markets. There's plenty of investor money in China, Russia, the Middle East, as well as the U.S. The rest of the world has developed to the point that, if the U.S. goes into a recession, I don't think we'll have a global recession. It's too early to tell how this will shake out. The markets will eventually normalize, but things have changed.”

John Mack, Chairman and CEO, Morgan Stanley

"Two developments-securitization and the seamless interconnectivity of markets-have brought intricate quantitative risk modeling to the forefront of financial practices. Securitization generates market prices, while information technology offers the power to quantify or pricing and risk relationships. Few recognize, however, that such modeling assumes constancy in market fundamentals. This is because modeling does not adequately account for underlying structural changes when attempting to calculate future prices and risks. At the heart of the long-term underlying challenges that face the US financial system the question of how to enforce discipline. What is missing today is a comprehensive framework that pulls together financial market behavior and economic behavior. It is urgent that the Fed take the lead in formulating a monetary policy approach that strikes the right balance between market discipline and government regulation. Until it does so, we will continue to see shocks of even greater intensity than the one now radiating outward from the quake in the US subprime mortgage market."

Henry Kaufman, President of Henry Kaufman & Company, Inc.

"These sorts of things are what's known to the academics as "endogenous to the system"--that is to say, they're normal. They happen usually every three to five years."

Bill Miller, Chairman and Chief Investment Officer, Legg Mason Capital Management

"We have been in a spectacular boom in both stock and housing, and there's a psychology associated with that. That boom psychology brought us lower lending standards and a lot of wishful thinking about how easy it is to make money, and both real estate and stocks have been at record highs. But now they seem to be heading downward. It's possible that we are at a major turning point, but I'm not sure. So far, I don't see any major change in investor psychology. It might slow down the economy and put us in a recession, but we'll emerge from it, and many people will be better off."

Robert Shiller, Stanley B. Resor professor of economics, Yale University

"We don't know how bad this gets. The problem is we don't know how bad the hole is. At the individual level, what's happening right now is probably an argument for indexing and not taking the risk of individual stocks."

Jim Chanos, President and founder of Kynikos Associates

"The lack of monetary discipline has become a hallmark of unfettered globalization. Central banks have failed to provide a stable underpinning to world financial markets and to an increasingly asset-dependent global economy. Is this any way to run a modern-day world economy? The answer is an unequivocal "no." The current financial crisis is a wake-up call for modern-day central banking. The world can't afford to lurch from one bubble to another. The cost of neglect is an ever-mounting systemic risk that could pose a grave threat to an increasingly integrated global economy."

Stephen S. Roach, Chairman, Morgan Stanley Asia

"We knew these corrections would come. The surprise is the degree of volatility and the effect on liquidity, especially short-term liquidity. The very substantial changes in the financial markets over the past five years have presented new challenges. We have new players: foreign investors, hedge funds, and private equity firms. And we have new products--more complex products than in the past. The changes do distribute risk more broadly, but they've contributed to the uncertainty. Where does it go from here? The longer there's risk aversion, the greater the impact on the markets. We don't see broad signs of weakness in the economy, and that's what matters most. Global economic growth is expected to remain strong. There's a continued acceleration in exports. And corporate balance sheets are strong."

Amy Brinkley, Chief risk officer, Bank of America

"Today, the Federal Reserve and the other major central banks have been forced to look under the hood of the global financial system once again to try to understand how growing defaults on subprime real estate loans in the U.S. have triggered declines in the prices of high-quality assets and the drying up of credit even for sound borrowers around the globe. Once the turmoil has subsided, the Federal Reserve should look under the hood once again to try to figure out exactly what went wrong with the mechanics of the global financial system this time around."

Laura Tyson, Professor, Haas School of Business, University of California, Berkeley