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Capital Ideas

The Best and the Brightest

This recession just keeps dragging on. Yesterday another friend called to let me know he had become a statistic. He had worked for one of the largest fund companies in the world for many years. That company has seen its assets under management cut in half. Part of the drop in assets was due to market action. But part was disintermediation due to investor's belief that the company had let them down. They had held up well in the 2000—2002 technology collapse because they did not play that game. As a result - not for the reasons that they were relatively unscathed, but simply because they were—their assets grew incredibly. They hired staff to handle the growth. In some areas they over-hired without contemplating another downturn in the market.

Then came this recession. Their funds did not hold up as they had in the last recession. The conservative bent of the firm's investment policy put their funds where the most damage occurred, primarily in financials and other dividend-paying stocks. But this collapse spared no quarter. Domestic stocks and bonds, foreign stocks and bonds, real estate, everything, everywhere.

So the company lost about half a trillion dollars in assets under management. When that happens, heads roll.

My friend's company is not alone. Every day, we read or see something about the auto industry and the financial institutions. I see more and more going (or gone) out of business signs on stores as I drive to and from work. Big business, small business. Here in the US or abroad in Europe, Asia, and elsewhere. The global economy is adjusting to the new reality.

How did we get here? The easy answer is Wall Street greed. The Bear Sternes, Lehmans, AIGs, Royal Bank of Scotlands of the world—not just Wall Street—hired young guns from the best business schools, as they always have, to produce products to be sold to institutions and individuals. We celebrated these young bucks as they made the economy grow at a time when there was scant reason for the economy to grow. They created "new" financial instruments like credit default swaps and structured investment vehicles (SIVs) to meet special needs. Their testing showed that the chance of failure was miniscule.

Things change. The unthinkable occurred and the house of cards came down. How could they be so smart and so stupid at the same time? Didn't they study in B-school the deleterious effect that "portfolio insurance" had on the market collapse in 1989? It is as if they had Frank Zappa's *It Can't Happen Here* on continuous loop in their iPods (for the uninitiated: "It can't happen here. I'm telling you dear that it can't happen here. Because I been checkin' it out, baby. I checked it out a couple times. … Who would imagine they would freak out somewhere in Kansas.…")

Leverage (borrowing) became a bad thing and everyone had lots of it. Corporations, consumers, governments. Now the new mantra is de-leveraging. This is the new reality.

Companies are downsizing whether they like it or not. Consumers are consuming less whether they like it or not. And, as a result, portfolios, retirement plan assets, and savings of all sorts are downsizing, too.

The Dow is up 30% from its low. Yet it is still down nearly 40% from its peak. I am not complaining about recent market performance (Go, Dow, go!) I am just trying to keep it all in perspective. Until the de-leveraging is complete, we must have realistic expectations for our lives and our portfolios.

As long as money is tight, the now-debunked model of the recent past is dead. We are not going to be able to borrow our way to prosperity.

We can see the painful adjustments all around. The most obvious and painful is the loss of a job by a family member, a friend, or ourselves. I graduated from college and law school during recessions. I know what it is like to look for work when companies are not hiring.

Companies hire in response to consumer demand. You can't build cars when consumers are not buying (unless you can get taxpayer money). You can't hire new lawyers when cash is tight because individuals and companies cut back on legal services.

I hear financial professionals talk about places in the market where returns will be good. I have heard people who should know better preach that the BRICs (Brazil, Russia, India, and China) are the place to be. That may be true over the next fifty years but not for the next five. Those countries have manufacturing-based economies and they do not have a sufficiently large domestic market to grow without buyers in the "developed" world.

I hear others speak of guaranteed incomes for life without taking inflation and other factors into consideration. I hear so many things that make me wonder whether we have learned anything.

There are better days ahead. Of that I am certain. But do not be fooled by this recent market rally that we are headed back to 14,000 on the Dow in short order. We will eventually get there. But it will take a while. This is not a small recession. It is a big one.

The early decade market difficulty was very different. Euphoria in the technology sector led to a bubble that collapsed. This one took down all companies. It also took down debt instruments (bonds). The financial infrastructure is in shambles. The government is still borrowing against its ability to tax you and me to shore up industries it fears still might collapse and send the economy into a tailspin.

We are not there yet. The de-leveraging will take years, not months. It will happen. It takes time. First, corporations and individuals need to de-leverage. Then, it will be the government's turn.

But out of this collapse will come new businesses and new jobs. The best and the brightest will be hired in these new business. The energy field is one getting great play now, but the payoff is years down the road. Education has an opportunity to pick up people who otherwise would be going to private industry. Creative minds will create new jobs.

We all need to adjust to the new reality. We need to realize that things have changed. We need to adjust our expectations. We need to find ways to employ the talent that is now out of work. We need to accept the challenge before us. We need new answers to old questions.

We need the best and the brightest. Now.

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