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The Day the World Stood Still

Exactly a year ago, on September 15, 2008, the world stood still when Lehman Brothers collapsed. In what was to be a monumental blunder by then Treasury Secretary Hank Paulson and Fed Chairman Ben Bernanke, the 145-year old Lehman lapsed into bankruptcy without any assistance from the government.

Investors were expecting to see Lehman bailed out by the government, especially after mortgage giants, Fannie Mae and Freddie Mac were rescued the previous weekend. Six months earlier, the government supported JP Morgan's $29 billion takeover of Bear Stearns.

So when Lehman was not rescued, panic set in, unleashing a global market mayhem and economic turmoil not seen since The Great Depression. For investment banks and money managers, it was as if the world ended on that day.

Warning from Uncle Wash

In the months leading to that fateful day, US regulators tried to do every trick in the book to stem the crisis, but failed. They lowered interest rates and injected money into the credit markets, but the mortgage woes and liquidity problems spread.

In fact, Washington Sycip (Uncle Wash for most of us) warned us in one of our board meetings that the likelihood of a large US bank failing was extremely high. He intimated to some of us that it would be Lehman that will collapse. Consequently, in one of our succeeding articles, we mentioned that what would happen next would be one for the books.

Shockwaves across the globe

The problem was that people were expecting a much orderly process similar to Bear Stearns. However, Lehman was just allowed to crash. The reasons why Paulson and Bernanke did not step in at the last minute may never be clear, but the devastation that it cost the global economy were clearly underestimated.

The events that immediately followed have been well documented in Philequity Corner. On the same day of Lehman's collapse, Merrill Lynch agreed to shotgun marriage with Bank of America. Stock markets plunged worldwide. Credit markets froze. Even money market funds (considered one of the safest investments) received massive redemptions as Treasury yields fell close to zero.

Recognizing its mistake and with panic setting in, the US government was forced to bailout insurance giant AIG for a tune of $85 billion only two days after abandoning Lehman.

Who is next to fail?

Because they allowed Lehman to fall, investors were wondering who could be next. In the days that followed, the stock and bond prices of Morgan Stanley and Goldman Sachs (the last two of the Big Five investments banks) collapsed and their credit default swaps rose to a record.

In the week that followed, Goldman Sachs would receive a $5 billion capital infusion from Berkshire Hathaway in the form of convertible, preferred shares. Meanwhile, Morgan Stanley would receive $9 billion from Mitsubishi UFJ Financial Group in exchange for 21 percent ownership. In other parts of the globe, some banks would be nationalized, some would be merged, and still others would fail.

The cost of Lehman's collapse

The cost of rescuing Lehman would have been small compared to what its failure imposed on the global economy. At its demise, Lehman ended up with an estimated $85 billion worth of toxic assets on its books. Many now believe that the $700 billion bailout by the US Congress would not have been necessary if Lehman's implosion would have been more orderly. In the end, the cost by governments worldwide - in terms of fiscal incentives, stimulus programs, guarantees and equity infusions to the financial sector and certain industries - would amount to trillions of dollars.

The catastrophic effect on the markets

In the same manner, the damage done to the markets would not have been that catastrophic if not for Lehman's collapse. The S&P 500 index would not have plummeted to 666.

Prior to the collapse, the index stood at around 12,000. What should have been a typical market downturn due to a recession turned into a great panic discounting a global depression.

Meanwhile, the PSE Index, which stood at around 2,750 in the early days of September 2008, would not have fallen to as low as 1,684 the next month.

Recovering from post-Lehman trauma

Governments world-wide have learned their lesson from Lehman's demise. The swift and coordinated action by central banks and fiscal managers has stabilized the global financial system. Massive fiscal spending and record-low interest rates appears to have worked, helping the global economy recover from the impact of the worldwide recession.
Most emerging market countries have already shown positive economic growth in the 2nd quarter of 2009, while developed economies like the US is expected to be back in the black this 3rd quarter.

With regard to financial markets, the recovery was much faster than earlier expected. Most emerging markets, such as the Philippines, are back to pre-Lehman levels (see the chart above). Meanwhile, the major US market indices appears to be heading towards the same direction.

Skeptics are still aplenty

With the markets bottoming-out in March and the global economy showing early signs of recovery, many remain skeptical. Just like last year, when the markets were plunging, no one believed that prices would go down to such extreme levels.

Today, many are still unconvinced that we are in a bull market and prices can go higher. In fact, for several weeks now, many brokers, analysts and market experts have been expecting a correction. But with interest rates still at record low levels and economies recovering from recession, the path of least resistance for stocks should continue to be up.

Whether the correction will come this month, in October or in November, no one really knows. What is important is that the long-term trend is up. And if you have a two- to three-year horizon, we believe that even at current prices, stocks are poised to deliver very decent returns.

Rich people can be stupid too

Rich people can also be stupid, especially if greed is involved. They can be meticulous when they buy something. They will study the specs, look for options and bargain with the price before they commit. For example, they will make sure that they buy only a Mercedez Benz car from Germany or a Sony TV from Japan.

But when it comes to investments, they become haphazard. They will just rely on the advice of the private bankers without doing their own studies. Many bought into Kazakhastan bank bonds or Ukraine bonds without studying them. Others dabbled in structured products such as equity-linked notes, knock-in knock-out options, accumulators, etc. without knowing the risks (refer to our article *Bad Word* in the November 17, 2008 issue of **The Philippine Star**).

Lessons from Lehman

As we look back on that fateful day of September, we share with you some valuable lessons from the crisis. Hopefully, investors would take heed so that costly mistakes would not be repeated.

1) Study what you buy and buy what you know. Do not trust you private banker, investment advisor, stock broker blindly. Do your homework.
2) Rating agencies can be wrong. Look at what happened to once AAA-rated stocks such as Fannie Mae and Freddie Mac.
3) Be careful of leverage. Never overextend.
4) Follow the wisdom of diversification. Spread your money across a number of assets.
5) Be disciplined. Understand your risk exposure.
6) Stay away from structured products and derivatives if you don't have the knowledge. Stick to what you know and understand.
7) If returns are unusual, be very careful. There must be something amiss. Maybe the returns are amplified by leverage.
8) There is no free ride. Your stock broker, investment advisor, or private banker will not make you rich. Trust your own judgement.
9) Emotions can cloud your judgement. Do not trade based on greed or fear. Those who did bought at the top and sold at the bottom.
10) Do not panic. While the market may be dictated by sentiment in the near-term, it reverts back to fundamentals over the long-term.
11) Learn to cut losses, especially if fundamentals change just like what happened in 2008. Learn to sell to be able to fight another day.
12) The unthinkable and unexpected can happen. So be prepared.
13) Always have cash in your portfolio as part of your diversification. You may never know when you will need cash, especially in times of crisis. Moreover, if there is a big downturn in the markets, you can take advantage of the opportunities if you have cash on hand.
14) It is more prudent to invest in liquid markets such as the US rather than go into exotic countries where you don't really know what is happening. Or better still, invest in your own country and in things you are familiar with, e.g. Philippine stocks, Philippine bonds, Philippine mutual funds and ROPs.

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