



## Investment Implications for Government Policy and Intervention

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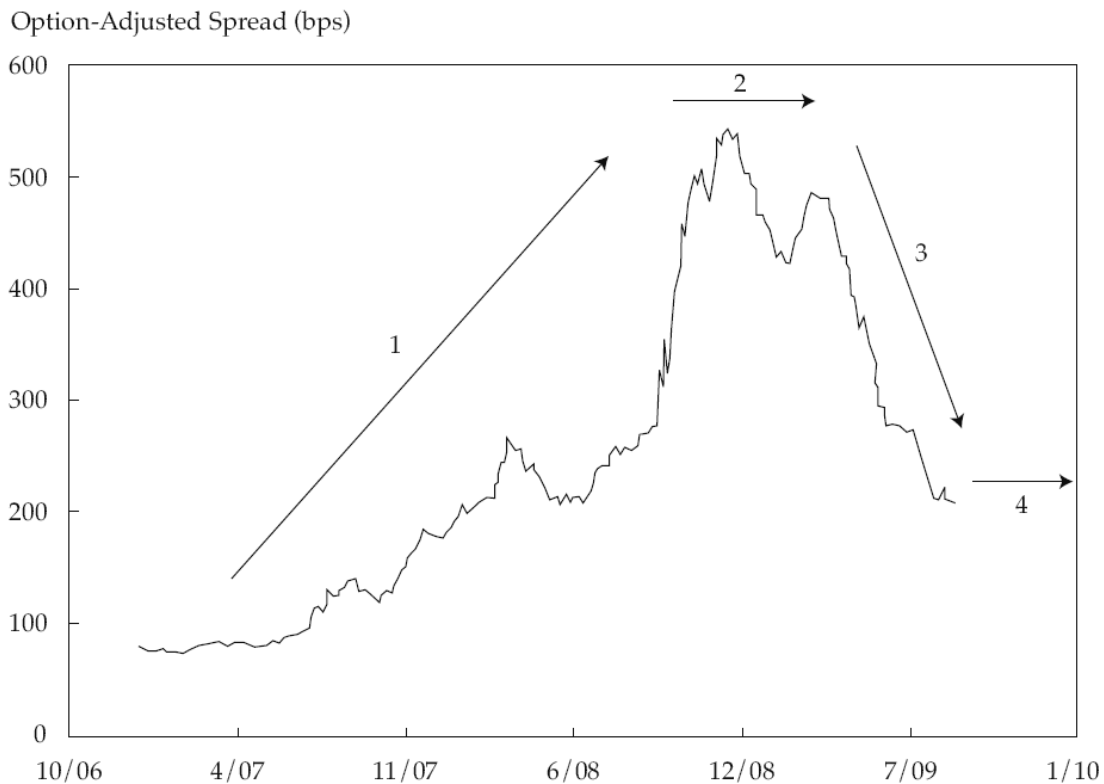
Decision making under uncertainty is one of the greatest challenges faced by anyone in authority, and I believe that policymakers around the globe have done a remarkable job of dealing with an array of unknowns. Furthermore, what the U.S. Treasury and U.S. Fed are doing is critical to fixed-income markets, equity markets, and the economy in general. One of my main goals, therefore, is to discuss how the decisions already made by policymakers and the decisions they are likely to confront have affected and will affect the markets.

To begin, I will offer a market update and my own particular perspective of the recent crisis in the markets. I will follow that with a historical perspective of the U.S. banking system. After that, I will discuss policymakers' interventions, some of the economic headwinds that will probably continue to confront both the economy and the markets, and the ways in which policymakers are likely to react. I will then describe current and expected asset allocation trends and identify some of the opportunities that the markets seem to be presenting. I will conclude by identifying some of the lessons that we should all have learned from this challenging period we have just experienced.

### Overview of the Financial Crisis

The crisis of the past two years can be divided into four distinct periods, as **Figure 1** illustrates with a graph of investment-grade option-adjusted spreads. A graph of high-yield or commercial mortgage-backed securities (CMBS) yield spreads would look similar.

**Figure 1. Four Periods of the Financial Crisis Reflected in Investment-Grade Option-Adjusted Spreads as of 31 August 2009**



Source: Barclays.

**Period One: Mid-2007 to Late 2008.** The first period incorporates the market sell-off—that is, the liquidation of over-leveraged investors—that began around the middle of 2007 and did not end until late November 2008. Because of the various mechanisms to lever assets, spreads had become incredibly tight, and a gigantic margin call occurred.

From my seat at BlackRock, the most dramatic play was the unwinding of the equity plus funds. The general strategy of such funds is to buy stock futures instead of stocks and use the cash to buy high-quality fixed-income assets. If investors are fully invested and the stocks go down, the investors must sell some of their assets to make the margin calls on their futures contracts. Most managers of such funds ran with some cash but not too much because running with too much cash would neutralize the plus part of the return. BlackRock managed a small amount of equity plus money but was not one of the largest players in that market. Nonetheless, we watched the markets with fascination.



The stock market became incredibly volatile, with sell-offs of 57 percent, and by late Friday afternoons, when most employees were gone for the day, equity plus managers were confronted with multi-billion-dollar bid lists coming into the market. Unfortunately, the buy side had no liquidity. The buy-side managers could see the equity plus liquidations coming because the equity plus managers and their investors had to make the margin calls or face even more dire consequences. Therefore, shorter-duration, high-quality assets were dumped because everyone was seeking proceeds. No one was doing credit analysis. Equity plus managers had neither the time nor the presence of mind to run credit fundamentals and determine what they should be selling. The situation was chaotic, and managers were simply selling off the assets with the highest dollar price they could get. We were buying high-quality, nine-month paper at 12 percent yields because managers and investors needed the cash. That was a dramatic period.

**Period Two: Late 2008 to Early 2009.** Although less dramatic, the second period was perhaps the most interesting of the crisis. From late 2008 to early 2009, almost all investors believed that assets were too cheap. Valuations were attractive, but the environment was uncertain. Analysts could see that even though houses were being liquidated at prices far below their prebubble trading value of 2002, with the inclusion of land values, loss-adjusted yields in the nonagency mortgage market were, in some cases, in the teens. There was nearly uniform agreement over value, but fearing further losses, no one would play. And no catalyst existed to encourage anyone to do so.

### **Period Three: The Catalyst...**

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