ADVISOR PERSPECTIVES

Mohammed El-Erian:
"Resist the Temptation to Automatically Rebalance"

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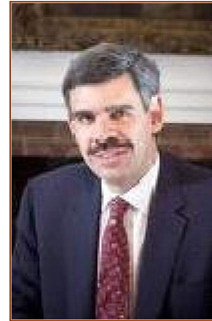
December 9, 2008



In an address to institutional investors on December 2, PIMCO CEO and co-CIO Mohammed El-Erian provided a comprehensive analysis of the current credit crisis, along with guidance for investment strategy. Traditional rebalancing is not the way to go, he said, and investors should go up the capital structure instead of increasing equity positions.

"There is no reset button" to cure the credit crisis, El-Erian said. "The dislocation is occurring at the heart of the financial system – not at the periphery – and it follows that the normal circuit breakers will not work."

Current de-leveraging is "a process that is indiscriminate in its path," he said.

To underscore how remarkable the current crisis is, El-Erian asked how an impartial observer would have responded just six months ago to the following possibilities:

- The next global crisis would originate in the most advanced financial system in the world;
- Newspapers would report that people are lining up outside banks to withdraw money – not in a third world country – but in the US and the UK;
- The Fed would announce six emergency policy measures, including at least one that was announced on a Sunday night;
- Congress would arm the Treasury Secretary with a "bazooka" (the TARP) to disburse funds to buy assets;
- Major portions of the financial system would be nationalized;
- Even after such unprecedented events, the financial markets would remain in a state of extreme crisis.

Such a thought would have been regarded as fringe predictions at best, he said but the truth is that everything has occurred, and much more.

"There is no master plan for fixing the crisis," said El-Erian, and officials "don't have the luxury" of figuring one out. Instead, they have so far mainly focused on ad-hoc crisis management steps.

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Policy decisions are following a sequential path, addressing successively wider concentric circles of asset classes, El-Erian said. Officials initially focused on short-term assets and inter-bank lending, while subsequent steps were aimed at mortgage-backed assets and consumer credit. But as the size of the targeted asset class has grown, more money is needed to stabilize the markets, and implementing responses has grown increasingly difficult. The result is a sequential and drawn-out healing process.

How did we get here?

El-Erian ascribed the roots of the crisis to a concept first put forth by NYU professor Nouriel Roubini, who described a "stable disequilibrium" — a host of global structural imbalances that were well-known but nonetheless allowed the financial system to remain stable.

These imbalances included risk management systems that were too slow to evolve, a disproportionate focus on short-term results, and massive innovations that lowered the barriers to entry in the structured finance industry.

Underlying these imbalances were a natural human tendency to overproduce and over-consume, according to El-Erian.

El-Erian cited a series of de-leveraging processes triggered by the crisis. Balance sheets throughout the global economy are contracting simultaneously. "It is like a building on fire, and everyone is trying to get through the door at the same time," said El-Erian. "The financial system is slimming down," he said, with consumers and the rest of the world following suit.

As a result, "every single asset class is under pressure," he said, adding that the system cannot accommodate current levels of selling pressure. Buyers can see the massive global de-leveraging and hold back until prices stabilize, but sellers cannot afford to wait, forcing prices lower.

De-leveraging is occurring throughout the economy, and not just in the financial markets. El-Erian described a "massive economic slowdown" and forecast a GDP contraction of 4-5% for the fourth quarter over the preceding year. Every single economic indicator has "fallen off a cliff," he said.

"We don't have the right structures to deal with this at an international level," El-Erian said. The G7 does not include key players like China and Brazil, he explained, but the G20 is too big to be effective. "There is an institutional failure at the international level."

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Implications for Investors

When the system recovers, El-Erian said, it will be dramatically transformed. To illustrate the coming transition, he compared Wall Street past and present to the game of Monopoly. Until recently, Wall Street focused on collecting blue and green properties — the game's priciest — adorned with the most expensive houses and hotels. But future Wall Streets will more resemble the Utilities – slimmed down institutions with less risk and a much lower return on equity. "This has massive implications for investors," he said.

De-leveraging causes indiscriminate selling, and the challenge "is to recognize that there is value in certain parts of the capital markets."

El-Erian divides the capital markets into three categories of assets. Type A assets are dislocated in ways where it is possible to identify the catalyst that will bring back value. These include assets that the government is or will be purchasing. Type B assets have been dislocated and have value, but lack a catalyst to re-establish that value. These assets will trade at their dislocated values for some time. Type C assets are not coming back, because the world has changed. These are legacy assets that should be liquidated.

Investors should think differently about getting the right asset allocation, choosing the right investment vehicles, and having the right risk management.

"Traditional asset allocation is fatigued and will no longer produce the same returns," El-Erian said.

Investors should not automatically rebalance portfolios, he said, because doing so implies increasing allocations to equities. He believes there are better opportunities in other asset classes. He would avoid equity in asset classes where the government is taking ownership positions, especially the financial sector. Government positions will be in preferred stocks – senior to common equity – and, because the government must safeguard the interests of taxpayers, their interests may not be fully aligned with those of common equity holders.

If avoiding rebalancing is not an option, El-Erian said investors should consider going "up the capital structure to get a higher return" and should look at "special opportunities" – asset classes that do not fit nicely into traditional categories. He did not say specifically which special opportunities he considered attractive.

"Diversification was valuable in the past, but we are in a new world," he said, adding that investors need to manage risk more aggressively through tail insurance. [El-Erian discussed the concept of tail insurance in our interview with him on July 22.]

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El-Erian expects a fiscal stimulus package of $500-$700 billion, but he declined to say whether he believes this policy will be successful in restarting the economy. The immediate concern should be restarting the banking system, which has been the recipient of major liquidity injections, he said. El-Erian expects this liquidity to "take hold" in mid-2009, at which point inflation will become a concern.

"There are very attractive opportunities today as a result of de-leveraging," he said. TIPS have been "massacred" over the last few months, because they were held by levered investors. Their valuations are very attractive and "will make money relative to nominal bonds even if there is no inflation," he said.

Commodities are also depressed because of de-leveraging. El-Erian noted that airlines hedge when oil is at $120/barrel but not at $80/barrel, which causes prices to overshoot on the way up. On the way down, oil exporters reduce production, causing prices to undershoot. "Most commodities have undershot, and there is value in them going forward," he said.

The de-leveraging process is about three quarters complete, according to El-Erian. He admits there is a lack of hard data to back this up, and bases this on information coming from PIMCO's involvement in so many markets. He said the last quarter of the de-leveraging process will be very strange, and will be a "consistent stream" of selling by those institutions who can afford to wait and sell only when the market improves. This phase of the de-leveraging process will be drawn-out.

"We are living in a world where the unthinkable is thinkable, and we don't have as many insights as we would like," said El-Erian. Investors should err on the side of caution, focusing more on the risks of being wrong than the rewards for being right.

"Resist the temptation to do what has done so well in the past, such as automatic rebalancing, and don't take too much risk," he concluded.

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