



Global Asset Management

- Leader: **André F. Perold**, *George Gund Professor of Finance and Banking*

Overview

The financial crisis can be characterized as contagious, with one market after another falling like dominoes. In total, the world has lost around \$60 trillion in wealth due to declines in equities, real estate values, and the value of private firms. Rating agencies and leverage are responsible for many of the financial system's problems.

While cliché, what is needed is to restore confidence to the financial system as all aspects of the system require confidence as a basic underpinning.

Context

This session discussed the basics of the financial system, the scope of the current crisis, and the reasons for and impact of the crisis.

Key Takeaways

- In a very short period of time, the world has lost \$60 trillion in wealth.**

The world finds itself today in a new financial environment. Just a year ago, there was a vast scope of investment opportunities ranging from hedge funds to private equity. There were new asset classes, new financial instruments, and new tools for tailoring risk. There was excess liquidity and high asset prices.

The growth in the value of the world's assets had been immense. In 1990, the world's equities had a total market of \$9 trillion. By the end of 2007—just 17 years—this had grown more than five times to \$61 trillion. There was an extraordinary increase in world wealth. The market capitalization of equities in developing markets grew from just under \$9 trillion to \$32 trillion. The value of equities in the emerging markets increased from \$700 billion to \$19 trillion. Even large, developed markets grew significantly. The market capitalization of U.S. equities went from \$3 trillion to \$18 trillion during this period; the value of Japan's equities increased from \$3 to \$4.5 trillion, and the United Kingdom's equities expanded from just under \$1 trillion to \$4 trillion.

The environment is starkly different today. There is no liquidity and much lower asset prices. Just the day before the Centennial Summit, the market experienced multiple intra-day moves of 10%—as equities increased and decreased in value by 10% on the same day. The infrastructure sustained this volatility without any problems.

In total, in just the last few months, the world has lost around \$60 trillion in wealth, across equity markets, residential housing, commercial real estate, and in private firms. In light of these huge losses, it is hard to believe that people will not behave differently moving forward.

"When we are living in a world of intra-day swings like this, it tells you something about the state of uncertainty in people's minds."

— André F. Perold

- The financial system brings together those who want capital and those who have it.**

The financial system brings together those who save money and those who need money through various intermediaries. When all is working well, everyone is happy: the savers save and the value of their savings increases; those who need money are happy because they get access to it; and the intermediaries are happy because they make money on the transaction.

But at the current moment, no one is happy. The value of what the savers have saved has declined; the spenders can't get access to capital; and the intermediaries have blown up.

- Ratings agencies bear tremendously responsibility for the financial crisis.**

The fundamental purpose of ratings agencies is to provide an independent, credible assessment about the risk of a company and/or financial instrument. Purchasers of securities, who may lack the time or ability to conduct their own due diligence, rely heavily on the ratings provided by ratings agencies in deciding financial instruments to purchase. These purchasers expect that something with a AAA rating is a high-quality, low-risk investment.

"The whole point of AAA is so that investors don't have to do research."

— André F. Perold

But leading up to the financial crisis, ratings agencies had, at times, what could be construed to be a conflict of interest: They were paid by the entity issuing the financial instrument they were rating. This led agencies to lower the bar on their ratings. As a result, some risky investments received AAA ratings.

"One of the great transformers of all time is putting garbage in and transforming it to AAA (and toxic)."

— André F. Perold

Further, ratings agencies are run by people who are not in the investment business. As the investment banks ran into trouble, the rating agencies quickly downgraded the banks, without any sense of the impact. These decisions were not made by people who fully understood the industry or the implications of their actions.

Professor Perold believes that the ratings agencies are probably the largest single cause of the current financial crisis. If there is one thing that could be fixed in the



financial system, it should be to create ratings agencies that are run by knowledgeable people and that have the right incentives.

- **Leverage has led to a massive reshuffling in the financial system.**

Leverage allows companies to make bigger and bigger bets. On average, the financial system is levered 15:1. So, in a good year, if a company makes \$100 billion in profit, it can reinvest this profit and borrow \$1.4 trillion to buy \$1.5 trillion in assets.

As long as the value of the assets increases and firms have the cash to pay for the money they have borrowed, all is good. But if those assets go bad or a company lacks liquidity, the company has to deleverage. It needs to sell its assets, likely at distressed prices. Occurring right now is a massive deleveraging, which has been taking place for the last year and a half.

The effects of this reshuffling have extended to the Federal Reserve. Traditionally the Fed has held Treasury securities, but it holds many other assets. This total reordering of who owns what is completely historic.

"We are in a massive reshuffle of the financial systems, where we need to unload assets on a grand scale."

— André F. Perold

- **Wall Street, hedge funds, and private equity have yielded tremendous compensation.**

An examination of Wall Street firms like Merrill Lynch, Goldman Sachs, and Morgan Stanley shows that these firms have been tremendous compensation engines. In fact, total compensation is typically about two times pre-tax profits. Consequently, for those Wall Street firms that have gone bankrupt, the shareholders lose the value of their equity, but the employees lose the goose that has been laying the golden egg, year after year.

But as great as the compensation of those on Wall Street has been, it actually pales in comparison to the compensation of those at hedge funds and in private equity. The flood of money into hedge funds has been astonishing. It is estimated that there is in excess of \$2 trillion invested in hedge funds and about another \$2 billion in private equity.

In the hedge fund world over the last seven years, the top ten hedge funds had total compensation of \$40 billion. This has led an enormous amount of talent to flock into the hedge fund world (including many HBS graduates). The success and huge compensation of those in hedge funds is based on the amount of money that has flowed into hedge funds and the performance of the hedge funds.

"Hedge funds, private equity, and Wall Street have essentially been compensation machines with some shareholders attached for a ride."

— André F. Perold

- **Derivatives are pervasive in the system.**

Derivatives are among the new types of financial instruments to manage risk. Their use is massive and pervasive. The over-the-counter derivative market is around \$500 trillion in total. At the end of 2007, J.P. Morgan alone had \$77 trillion in off-balance sheet positions, such as futures, swaps, and options.

On the whole, derivatives have worked well as financial instruments. Few individuals have lost money due to derivatives not functioning as they are supposed to.

"For most derivatives, it is extraordinary how well they work by themselves."

— André F. Perold

Other Important Points

- **Mark-to-market.** This is a highly controversial aspect of financial systems. Without marking an asset to its market value an investor doesn't know the value at a moment in time. But marking an asset to its market value at a moment in time can have consequences, such as forcing a company to increase its reserves or sell assets.
- **Index funds.** As Vanguard has documented, most of the time index funds beat actively managed funds, and do so at a lower expense ratio. An average person who simply matches the market performance when picking individual stocks is an overachiever.
- **Yale's endowment.** While Harvard's endowment has performed well, the performance of Yale's endowment, managed by David Swensen, has been stellar. (This follows a 50-year period where the performance of Yale's endowment was abysmal.) What Swensen did was allocate about 12% of the endowment to U.S. equities, a significant portion of the endowment to foreign equities, hedge funds, and private equity, and a small amount to bonds and cash. Other universities endowment managers have followed Yale/Swensen in herd-like fashion, but haven't matched his results.
- **Wall Street brain drain?** Some wonder whether the attraction of top talent to hedge funds and private equity has taken so much talent out of Wall Street that Wall Street companies are being run by the "B-team."



Speaker Biography

André F. Perold (Leader)

George Gund Professor of Finance and Banking

André Perold is the George Gund Professor of Finance and Banking. A member of the HBS faculty since 1979, he has served as senior associate dean, director of Faculty Recruiting, chair of the Finance faculty, and director of Research. He received his bachelor's degree from the University of the Witwatersrand, Johannesburg; and his master's and Ph.D. degrees from Stanford University.

Perold's research focuses on asset allocation policies of endowments and pension funds, the structure and evolution of the investment management industry, risk management and capital allocation within financial firms and hedge funds, short-selling constraints and market efficiency, and implementation costs within investment organizations. He has written numerous articles and case studies and is the coauthor of two books: *The Global Financial System: A Functional Perspective* and *Cases in Financial Engineering: Applied Studies of Financial Innovation*.

Perold teaches courses in investment management and capital markets in the MBA Program and in executive programs, including the HBS/CFA Institute Investment Management Workshop, which he has chaired since 1989. He has received numerous awards for teaching excellence and was voted the School's most outstanding professor in a 1994 *BusinessWeek* student survey.

Perold is a founder and chair of the investment committee of HighVista Strategies, which specializes in endowment management for institutions and individuals and offers a fund that is broadly diversified across marketable asset classes, hedge funds, and private investments. Perold has been a consultant to a number of financial institutions and investment firms and has served as a director, trustee, and an advisory board member of a variety of investment and other organizations. He is a director of the Vanguard Group and board chairman of UNX. He serves on the advisory boards of FIA Timber Partners, First Quadrant, the Rock Creek Group, and RRE Ventures. He is also on the editorial board of the *Financial Analysts Journal*.