Monthly Report for June 2010

Fund manager's strategy report

Wealth and risk

In this Monthly Report, I will try to reduce the current crisis, now a couple of years into its existence, down to a single perspective. While this may not be entirely fair given all of its facets, it could be helpful to sharpen our focus on a few fundamental aspects.

"Nothing in our world is without risk and nothing is free." These are not my words, but those of Adam Smith, the founder of the modern national economy. In his work "The Wealth of Nations", he explains the important role of risk in how the economy functions. As we know, when risk aversion among economic entities is too high, this can lead to a less-than-full maximization of the economic potential of a national economy. Without a certain appetite for risk, there would be very little entrepreneurial activity, for example. However, a willingness to take on a high degree of risk can have extremely damaging effects on the national economy as a whole.

Government-controlled risk allocation through legislation

The most important actors in a modern economic order are limited liability companies, whose liability is primarily limited to business assets. The personal assets of the owners are therefore not at risk. By legislating the issue of liability, the government has thus effectively allocated risk away from the owners of such companies and onto their suppliers, creditors and customers. According to Adam Smith, this redistribution of risk onto a greater number of actors leads to an overall increase in the willingness to accept risk within the system. The basic idea is similar to that of the insurance company business model, except that in the case of the LLC, the system is controlled by the government and its effects are "invisible". Even if the financial sector was, in fact, the root cause of the turmoil of recent years, government agencies are also at least partially to blame due to legislation aimed at protecting special interests or the overall deficiency of regulation. And by deficiency, I mean not just too little regulation, but also too much regulation in the wrong place.

Improper risk allocation

The result was ultimately an overall improper allocation of risk that led to the unfavorable separation of profits from their associated risks.

As we now know, the subprime crisis was a direct result of the failure of the profiteers of loan securitization to carry the risks of such transactions – aided not least by the greed for higher and higher profits on both sides.

The risks of junk assets were passed down, ultimately landing at the major banks and their poorly advised clients, where they exploded and brought the entire financial system to the edge of ruin. While average investors were forced to deal with the losses, in the case of the banks, the government quickly jumped in and took over the risks. As expected, this takeover of risk, coupled with fiscal policies to combat the economic downturn, damaged the creditworthiness and stability of governments (see also the July 2009 issue of our Investor Info).

The weakening of European nations as a result of the crisis is now being seen in the devaluation of the euro versus other currencies.

Perhaps the crisis would have never reached such dimensions in the first place if the profiteers had carried the risk even a short distance further. This principle is extremely relevant not just for entire national economies, but also for the asset management industry as well.

No passing of risk at ARVEST

The ARVEST philosophy, in place now for over three decades, of combining the interests of the company with those of the client is based on the idea of distributing risk in such a way that we profit only if and when our clients do. That way, we're always in the same boat as our clients. We believe that this concept, along with our core competency of dynamic asset allocation, is one of the main reasons why we are among Switzerland's top asset managers, and our performance thus far speaks for itself.

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