



BEHAVIORAL FINANCE SINCE THE '80s

ACT I - Lobby Hard to Repeal the Act

Beginning in the 1980s, the financial sector lobbied the U.S. government to repeal the Glass-Steagall Act which, for half a century, had separated commercial and investment banking activities. The Act was repealed in 1999. One of the best ways to influence human psychology is by using a simple, intellectual concept that can capture the public's imagination. Against the backdrop of Asia's financial crisis in 1997-98 and anemic economic growth in Europe, America's free market model shone. It is no coincidence, therefore, that ideas such as "free markets promote economic development" and "free markets have built-in self-adjustment mechanisms" were strongly promoted. Belief in deregulation gained currency in academia and the media to the point that it became globally thematic and dominated thinking in the public arena.

Banks developed strong lobbying efforts to enshrine deregulation and, with that, gained implicit rule-setting power in the deregulated arena. Between 1998 and 2008, the financial sector spent US\$5.1 billion on political contributions and lobbyists (Sources: Essential Information and The Consumer Education Foundation). By 2007, there were five finance sector lobbyists for each member of congress. To date, deregulation and free markets are still ingrained financial culture.

ACT II - Create Rules to Expand Balance Sheets

What basic underlying human behavior drives a free market? It is the pursuit of self-interest, i.e., greed. Die-hard advocates of free markets would go so far as to argue that greed is good for economic progress and that social and economic organizations should be driven by the aggressive pursuit of self-interest.

Bank profits are a function of business volume and the size of their balance sheets. Upon repeal of the Glass-Steagall Act, bankers set up new rules of finance designed to maximize balance sheet size and, hence, bankers' incomes. Securitization of loans and carried trades are prime tools used by banks to raise operating leverage by churning more business volume out of the same dollar of assets. Banks earn fees on mortgage loans. When those loans were securitized into ABS and sold to investors, another fee was earned. Cash released could then be used to originate another mortgage loan and fee income. Terms of rehypothecation are set up to allow banks to re-pledge securities (e.g., collaterals of carried trades and loans to hedge funds) without title transfer to other areas such as repo and share lending to further expand their fee asset base.

Off-balance-sheet structured investment vehicles (SIVs) were formed to buy ABS from their securitization conduits. Derivatives such as CDOs, swaps and equity-linked structured products were created to off-load balance sheet risks onto others. From 1999 to 2007, the "shadow banking" world of derivatives in securities and commodities ballooned—the business volume of CDOs and swaps done was many times the size of the underlying debts, and in essential commodities such as oil and grains, financial speculators often had bigger exposures than real user/buyers/producers.

High equity capital leverage ratio was the result of the expansion in balance sheet size. At the peak, each US\$1 of capital at Goldman supported over \$24 in loans and investments, and each US\$1 at Morgan Stanley, \$31.

ACT III - The Backlash

We all know what happened next—a bank run on the shadow banking world, the implosion of credit markets, extreme volatility in commodity prices and currency rates, and a global credit crunch. U.S. Treasury Secretary Geithner promised to set up new rules of the game, i.e., regulatory reform, and a Public Private Investment Program (PPIP) to create an active secondary market for the illiquid and hard-to-price pools of ABS still on banks' books.

Fear drove all global markets into a very heavily oversold situation by the end of 2008. Thanks to governments' frantic efforts to prime the pump, domestic stimuli and sellers' fatigue, a snapback occurred in the first half of 2009.

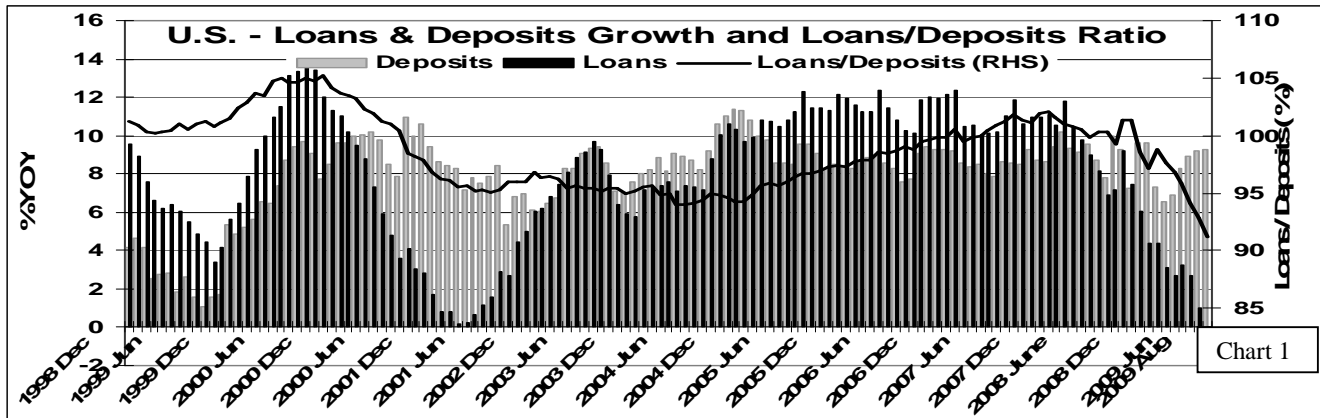
ACT IV - Wait and See During Political Fall-out

Now, in October 2009, new rules of the game are still pending. As financial conditions stabilize, political momentum for reform weakens. Financial sector lobbyists are working hard on the psyche of politicians about the dangers of over-regulation. As for PPIP, implementation momentum is so poor that it risks being quickly forgotten. The ABS securitization market remains frozen.

While rules are being redefined and the playing field is still uncertain, bankers' behavior is to wait and see, and they are

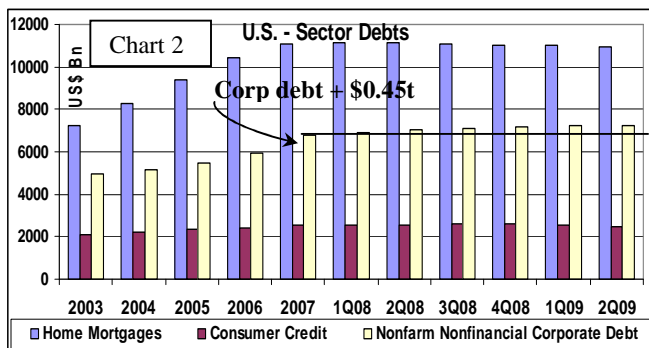
in no hurry to expand their balance sheets. Total debts in the U.S. have contracted (Charts 1-3 below) and U.S. banks' balance sheets are very liquid at present, with their advance-to-deposit ratios at a decades-low of 91%. Investment banks have downsized: Goldman's equity/asset ratio has halved, down to 14x, and Morgan Stanley's is down 40%, to 18x. The point to note: With the credit creation machine in neutral, U.S. economic growth is likely to stay subdued.

U.S. Bank Loans Fall on Absolute Basis and Are Down YOY

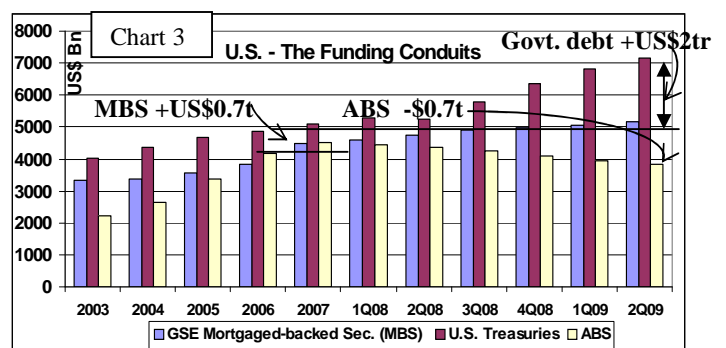


Corporate is the only private sector with expanding debt, due most likely to a recession-driven decline in cash flows. Outstanding ABS has shrunk by US\$0.7 trillion to a still sizable US\$3.8 trillion. Mortgaged-backed securities (MBS) from Fannie Mae and Freddie Mac have risen by US\$0.7 trillion, thanks to U.S. Fed purchases of 80% of new mortgages.

Contraction in Household Credit (-US\$0.24 Trillion)



Extent of Public Sector Credit Creation



Source for Charts 1-3: U.S. Fed, Flow of Funds.

Greed Factor Back on the Rise

An almost perfect (negative) correlation has existed between the dollar and stock market performance since mid-2008 (Chart 4). We believe the reason is that the dollar is being increasingly driven by capital flows of U.S. investors' purchase/sale of foreign securities. Note the faster decline of the dollar since August 2009—probably reflecting a rising use of the dollar (instead of yen) to fund carried trades. We have chosen Far East x Japan as our example, but the relationship holds true for other indexes as well.

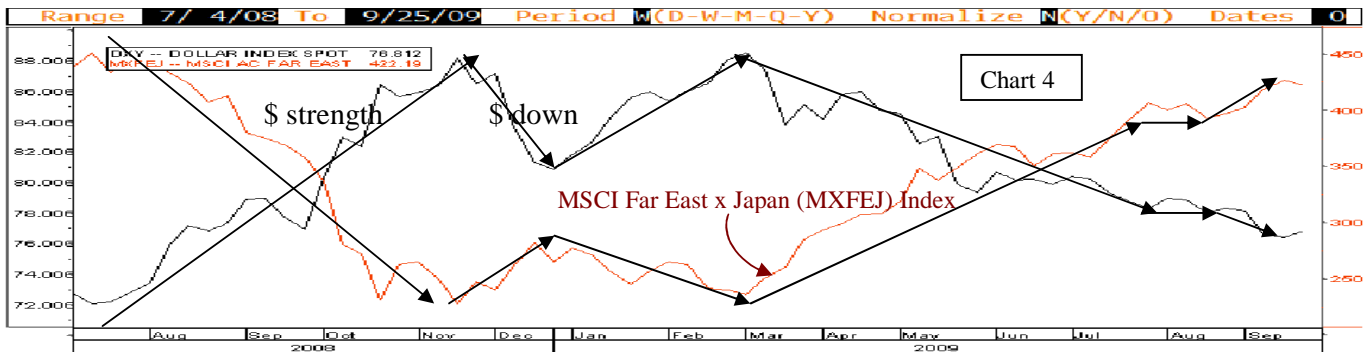
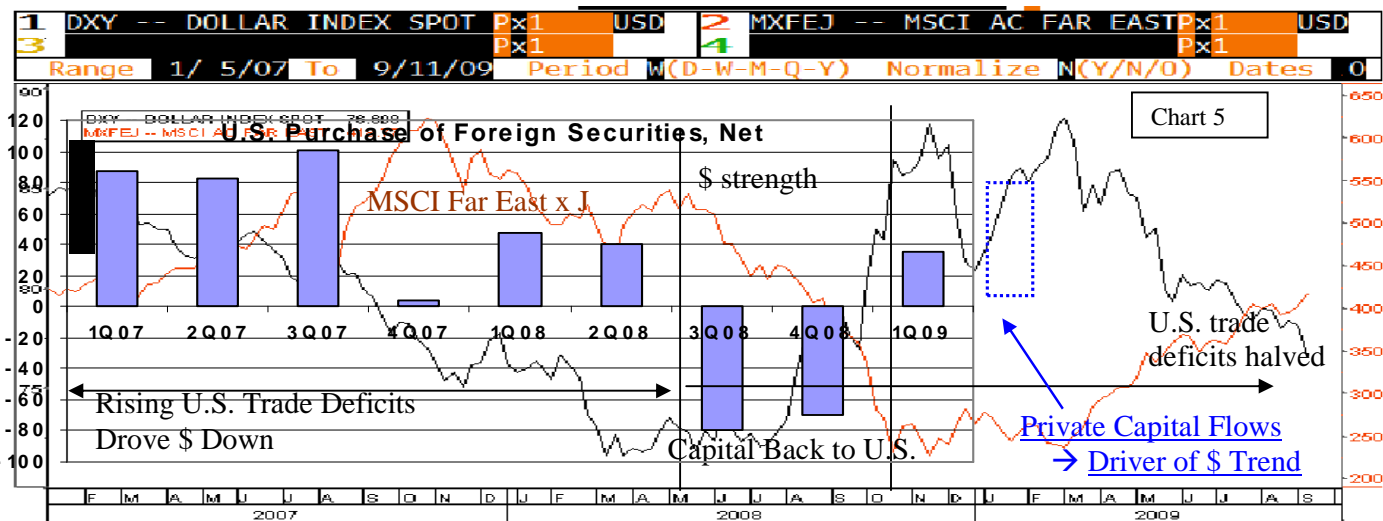


Chart 5, below, superimposes U.S. private sector purchases of foreign securities on the dollar index and stock market performance. Prior to mid-2008, the dollar weakened on expanding U.S. trade deficits, and correlation with MXFEJ was

less. Since mid-2008, the U.S. trade deficit has halved, making capital flows a bigger driver and, thus, creating a much closer correlation between the dollar and overseas stock market performance.

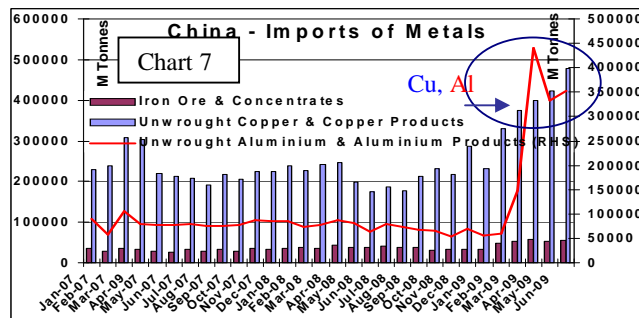
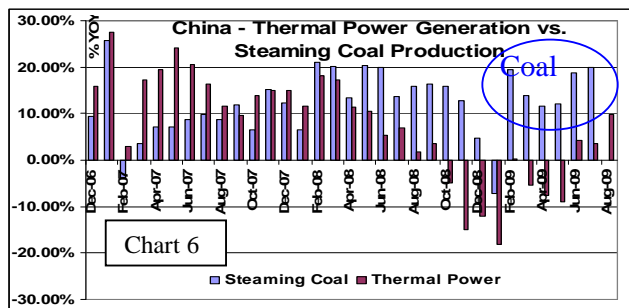


Source for Charts 4 and 5: Bloomberg, U.S. Fed.

Déjà Vu?

Old habits die hard as greed is an inherent part of human nature. Rising dollar-funded carried trades, should they continue, would drive a faster decline in the dollar. The dollar would thus be a useful barometer on the greed factor.

Surplus liquidity moving into speculative financial bets has certainly been seen in China/Hong Kong. China's A-share market, until August, was in a bubble-like advance (*The Issues, August 2009*). And there is evidence of liquidity, funded by the easing of bank loans, being used to stockpile commodities (Charts 6 and 7 below). In Hong Kong, Chinese money flow has propelled high-end property prices into the stratosphere.



Source for Charts 6 & 7: National Bureau of Statistics, China.

Conclusion

Additional evidence of speculative liquidity (from the rush of fund flows) at work in stock markets includes the 30% jump in the price of mega-cap HSBC in July/Aug (price-to-book value now over 2x), the US\$10 billion foreign inflow into the KOSPI Index in July and August (half of the YTD total net inflow into Korea), and the rally in commodity shares as investors rush for beta despite sluggish global demand overall.

As long as the ABS conduit stays dead, credit growth in the U.S. will remain subdued and ditto the U.S. economy. So, at some stage, concern over earnings fundamentals will return as the reality of a long U-shape for the course of the global economy sets in. The longer the current greed factor run, which probably began in July, the bigger the correction will come. But, of late, the dollar has bounced again, indicating a retreat to caution. The situation is still evolving so we will have to wait and see.

As discussed in previous *Issues*, we have been reducing our portfolio beta in favor of companies and sectors in Asia with sustainable earnings growth. They are likely to outperform within a slow growth global environment.

The Net Asset Values

GSI Asian Capital Growth--US\$20.98 and the Long/Short Fund--\$19.56 (Oct 2, 2009)