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The tyranny of conventional thinking

"What you as the City of London have done for financial services, we as a government intend to do for the economy as a whole."

- Gordon Brown, Mansion House speech, June 2002.

Bloomberg reported rather excitedly last week that Goldman Sachs has retained its appeal to MBA students despite the bad press the ~~brokerage company~~ bank has received over the past year. In a recent survey of 6,207 MBA candidates by Universum Group, the great vampiric squid and financial services firm kept its fourth place in a poll rating students' 'most attractive employers' behind, somewhat depressingly, consultants McKinsey and Bain & Co. Google was ranked first as most preferred prospective employer. MBA students can hardly be blamed for following the money, but one can legitimately ask why the opinions of MBA students are apparently so important given that MBA groupthink is surely one of the less examined factors behind the global financial crisis in the first place.

US President Obama last week took a leaf out of the UK anti-banker playbook and ignited his own jihad against the "obscene" bonus culture. Robert Jenkins of the London Business School articulated the problem well in a letter to the Financial Times:

"It would appear that when large banks do well, they are owned by their employees. When they falter, they are owned by their government. One would have thought that these institutions are owned by their shareholders. Well, we shall soon see..

"One investment trade body has warned that investors would not tolerate having to pay for bank employees' tax bills. They already have.

"The question now is, will investors and their agents do anything about it ? They certainly should. Bank boards have mistaken taxpayer-enabled profits for value-creating performance. The government knows this. Bank employees know this. Investors must know this. In coming months investors will have an opportunity to hold bank directors accountable. Shareholders should stand up by voting directors down. It is time we knew who owns whom."

Our view, which we have expressed on numerous occasions, is that investment in banking and investment banking businesses is rarely if ever justified. Banking may well rival the airline industry as a business that, since inception, has never actually generated a cumulative positive return for its investors. Rather, from time to time it has served as a cataclysmic furnace for capital. As Mr.

Jenkins rightly points out, in the good times, the profits of banking businesses are largely retained by the employees. In the bad times, not only are there no profits, but the liabilities are distributed speedily to taxpayers. Shareholders who insist in owning banking and investment banking stocks can, of course, wait for sanity and due accountability and ownership rights to emerge. But that may take some time. They are probably better off simply voting with their feet, and investing into businesses that create shareholder value, rather than destroy it.

There are some other, bigger, questions. It is worth asking not just why investors continue to invest into large, listed banking businesses, but why the clients of those firms continue to do business with them. It would be fair to describe the typical front-office employee of an investment bank, for example, as someone who "eats what they kill". In the typically zero sum game of investment, if investment banks are thriving from, say, taking trading positions, it goes without saying that their (client) counterparties to those trades will generally be losers (in an isolated if not a fundamental capacity). It may be fair to extend the analogy to the sales process. Whatever these firms are selling, it probably makes sense not to be buying. For those investors who insist on being counterparties with (former) investment banks, it would be churlish to complain at a later stage that they have been ripped off; rather, they should accept at the outset that the principle of *caveat emptor* pertains. But given the extent of taxpayer support for the banking system as a whole, that support also raises an issue as to the fundamental social utility – if any – of much of so-called casino capitalism. Bloomberg also addressed this issue in its story last week "Harvard MBAs pursue poker title as Vegas recruiters seek talent". Again, there's no reason to criticize MBAs for following the money, and at least this article makes the pursuit of wealth that much more transparent, as opposed to disingenuously citing the "high energy" or "quality of people" that working with the most successful former brokerage businesses supposedly entails.

There is a danger, in short, in applying traditional thinking to an industry that has recently revealed itself to be a house of cards. Indeed fractional reserve banking is, at all times, just a generalised sapping of confidence away from being a shell game – in its strictest definition of being "a confidence trick used to perpetrate fraud" – because there are ***never*** sufficient funds within the banking system to make good all depositors if they seek the return of their capital *en masse*. Admittedly, it takes a breathtakingly and scandalously large misallocation of capital to trigger that generalised loss of confidence. And as Shakespeare said, when sorrows come, they come not single spies / But in battalions. So a creaking financial system is now beset by conflagrations sparking up seemingly everywhere: Iceland, Ireland, Greece.. and it has government bond investors in traditionally safe markets (Japan, the US and the UK most notably) questioning the very validity of those markets given their monumental debt burdens. An ominous precedent was established last week when Markit's iTraxx Europe index, which tracks corporate debt, started trading at a lower spread than Market's SovX index, which tracks sovereign debt – implying, in other words, that Europe's governments had now become riskier than its corporates. Within this sort of "all bets are off" environment, investors slavishly following conventional thinking (that 'AAA' rated government bonds are riskless, for example) could be vulnerable to a once-in-a-generational involuntary separation from their capital, one way or another.

But how best to protect capital when so many risk assets seem expensive, or unanchored via government monetary interference to any semblance of fair value ? The World Economic Forum suggested in its Global Risks Report that a second leg in the financial crisis may be ahead, whether from a sovereign debt crisis, a further asset price collapse, an energy crisis through insufficient investment in infrastructure (and wasn't that British cold snap uncomfortable ?), or a "double-dip" recession. One answer is to be highly selective across all asset types, but notably with regard to (the most fundamentally sound) government debt and (a bias towards) defensive equities. Another, as Matterhorn's Egon von Greyerz suggests, is to put more faith in dispassionate and

unmanipulated gold rather than conflicted and deeply discredited governments (and financiers). As his recent article has it, it is not so much that gold is not going up – rather, that paper money is going down. And he quotes the seminal Austrian economist Ludwig von Mises in his admittedly gloomy conclusion,

"There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion or later as a final and total catastrophe of the currency system involved."

The western governments have moved the financial equivalent of heaven and earth to keep the increasingly ramshackle banking show on the road. Their supply of silver bullets is looking perilously shallow. To avoid the financial equivalent of catastrophe, conventional thinking has few answers for investors, only what look like blind alleys. "The new normal" requires fresh thinking and a somewhat unorthodox approach to the business of portfolio management. Capital preservation and the generation of absolute rather than market-relative returns are hardly eccentric objectives, but they might as well be to a craven banking and financial services sector still more concerned about securing its own wealth and privileges than delivering any form of economic value to its clients.

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