

Credit Crisis reinforces Asset Class Approach

The credit crisis that has gripped financial markets in recent weeks should not be causing our clients to lose any sleep. Particularly clients who have taken on board the principles of asset class investing that we strive to communicate.

The key messages remain the same-work with markets, not against them; remember that risk and return are related; diversify to wash away risk; concentrate on strategic asset allocation rather than speculation; and keep an eye on costs and taxes.

For Axiome's part, our processes are working normally and our disciplined, transparent investment strategies remain unchanged. Indeed, the wisdom of our long-term, patient approach to capturing compensated risk factors has been reinforced by the current turmoil.

What caused the crisis?

The crisis was caused by hedge funds and other leveraged investors chasing equity-like returns through opaque fixed income vehicles. In this case, the vehicles were asset-backed securities that used high-risk US sub-prime mortgages as collateral.

Sub-prime mortgages are housing loans granted to the least credit-worthy borrowers. These were bundled with other less risky investments into complex securitised vehicles called collateralised debt obligations (CDOs). While this bundling qualified the CDOs for a higher overall credit rating, it also masked their underlying exposure to the riskier and less frequently traded (or "less liquid") assets.

Many managers also sought to increase their returns on these CDOs through borrowing. But as defaults rose in the sub-prime market, they were asked to post further funds to support their borrowings, just as geared individual investors receive margin calls when their stocks fall in value.

This in turn forced the funds to sell equities and other profitable trades to cover their sub-prime losses- which partly explains why the credit crisis spilled over to equity, commodity and currency markets.

Why did central banks become involved?

Central banks became involved when what began as an upsurge in default risk started to broaden into liquidity risk.

Liquidity is the ease with which an investment can be sold and turned into money or with which money can be raised in debt markets. So in a liquidity crisis, even creditworthy borrowers like banks find it hard to source funding.

So the central banks have performed their role as lenders of last resort, providing emergency funds to the financial system at low cost to ensure the system keeps operating smoothly. This appears to have done its job for now.

How have the fixed interest funds used by Axiome been affected?

Axiome primarily gains fixed interest exposure for clients via Dimensional Fund Advisers fixed interest trust. This is **not** exposed to that part of the market that has rapidly deteriorated over the past few weeks.

Our fixed income trusts are low-risk strategies typically used to control volatility in a portfolio comprising both equities and fixed income.

We keep risk low by restricting investments to a broadly diversified portfolio of the most highly-rated, short-dated securities. This careful selection process excludes the securities which led to the crisis in credit markets.

We do not chase higher returns in fixed interest by taking on high levels of default or credit risk, as history shows that the underlying risks only become apparent when conditions become less buoyant, as we are seeing now.

What does the crisis mean for my portfolio?

The good news is that if you maintain a long-term view and stay properly diversified in a portfolio structured around **compensated** risk factors, you already have done what you need to do to ride through this turmoil. If anything, the events of recent weeks in global markets reinforce the benefits of this long-term, patient approach.

It is the nature of markets to go both up and down. Returns are variable. But if you have realistic expectations, remain diversified and disciplined and focus on capturing long-term asset class returns, you maximise your chances of having a successful investment experience.