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Bank Tidal Wave douses Wealth Management: In the wake of a crisis, investors may strike out on their own

By Donna Mitchell

The collapse of mortgage lender and thrift IndyMac Bancorp in July may not have begun with letters of warning from Sen. Charles Schumer (D-NY), but the financial services industry and the wealth management profession would do well to remember the subsequent events.

The senator's letters to several banking oversight agencies, including the Office of Thrift Supervision and the Federal Deposit Insurance Corp. (FDIC), triggered an old-fashioned bank run on Pasadena, Calif.-based IndyMac. Eleven business days later, depositors had withdrawn \$1.3 billion of the bank's nearly \$19 billion in deposits, before it was taken over by the FDIC.

That situation was just the beginning of a long weekend in the financial services sector. Mortgage giants Freddie Mac and Fannie Mae, suffering from an ongoing crisis of investor confidence of their own, were given a lifeline from the federal government, in the form of a temporary increase in their long-standing lines of credit.

According to industry observers, the slow-moving storm wreaked so much havoc in mid-July that it should send a strong signal to wealth management professionals: Do not take the basics for granted.

Indeed, there is reason to believe that one investment strategy that has received attention lately-going it alone with no advisor at all-may get even more consideration now.

"In this market, everything is upside down," says Michael Sonnenfeldt, cofounder of Tiger 21, a 160-member investment club for ultra-high-net-worth individuals. Financial advisors, he adds, have to maintain relationships with valuable clients at times like this. It's one thing for wealthy entrepreneurs to lose money on their own bets in, say, gold or futures-or even on bets recommended by wealth managers-when those wagers come with well-understood risk. But with regard to what Sonnenfeldt says are structural issues-meaning holdings in cash or cash-like auction-rate securities or Fannie Mae and Freddie Mac-wealth managers are often as much in the dark as their clients.

"[Wealth managers] have a business to preserve and sometimes they are not fully disclosing what they know-or what they don't know," Sonnenfeldt says.

Members of Tiger 21 do not always invest on the advice of a wealth manager, he says. Those who go it alone rely partly on the club's regular guest speakers and the collective knowledge among fellow club members. So as the troubles of mid-July unfolded, the reactions of Tiger 21 members were almost the same as they had been after two other recent blowups in 2008: They started communicating with each other directly.

One of those blowups unfolded over the spring, amid the freezing of the market for auction-rate securities. During that episode, some club members shared insights about the actions taken by their financial advisors to stabilize their portfolios. In some cases, Tiger 21 members received loans against those portfolios. Such information-sharing benefited the group because many other members were able to steer assets out of auction-rate securities before that market stagnated.

“A number of our members, in the last week or two, have been wondering whether the money-market funds that they had invested in were holding any Fannie [or] Freddie paper,” Sonnenfeldt reports. At press time, Tiger 21’s reaction to the current market woes was still unfolding.

Banking equity analyst Richard Bove, for one, was not quite ready to declare a material impact. “Wealth management is impacted by the markets, not bank-loan issues,” he says.

But even by that measure, things aren’t that great. By July 14, investors had spent a weekend digesting a diet of bad news about IndyMac, Fannie Mae and Freddie Mac-and watched that day as Treasury yields dropped on the 10-year notes and the 30-year bonds. Plus, investors were making a flight to quality away from volatility in other markets. Through mid-July, the S&P 500 Index had fallen 16% on the year; both the Nasdaq Composite and the Dow Jones Industrial Average had also dropped by between 15% and 16% each.

To be sure, not all high-net-worth investors will go it alone. Many of Tiger 21’s members, for example, have good working relationships with their wealth managers. But the club starts with the belief that wealth management is not a priesthood. “What our members are most concerned about is that the world has become more complex than ever before, more quickly,” Sonnenfeldt says. “Wealth managers who do not admit to that complexity and get on top of some of the core basics-and add transparency so their clients understand the risks-are in for some real trouble.”

One industry analyst explained the circumstances that connected the general-market downturns and the impact on the wealth management market by using history as a guide.

In the wake of the devastating failure of the savings-and-loan industry in 1989, the Resolution Trust Corp. was formed, and ultimately purchased \$125 billion in loans from the defunct banks and issued government-backed debt against them, Merrill Lynch economist Sheryl King wrote in a report dated July 14. That amount accounted for 2.25% of the prevailing gross domestic product.

In a worst-case-scenario of a bailout of Fannie Mae and Freddie Mac, the government might end up fronting some \$300 billion, or about 2.1% of today’s \$14 trillion U.S. economy, King wrote, adding that more phases in the financial crisis have yet to unfold. The housing market, for one, remains tenuous.

“The market is still dealing with almost a year’s worth of excess supply,” King wrote. “Home prices remain 15% to 20% overvalued nationally, in our opinion, and few cities can boast they are even close to fair range.”

Noting the impact of a previous 15% decline in home-price appreciation, King wrote that the next 15% drop is “unlikely to be any easier to swallow.”



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