



Max Bublitz

Creating a monster

Funds that are under government control have grown rapidly in recent years, to the extent that the architects of these funds risk losing sight of why they were set up in the first place

At a time when the previously unimaginable is becoming an all-too-painful daily reality in today's global markets, other more insidious changes are also taking place under cover of the capital market carnage. In fact, these other changes are likely to have greater longer-term consequences than the current assault on the financial system.

Over the last few years, the amount of money managed by some form of government-created entity has simply skyrocketed, both in terms of size and number of entities. Whether it's burgeoning global central bank reserves, sovereign wealth funds, or now TAF and TARP and their various acronym-based stimulus package brethren both in the US and abroad, these are pools of capital set up to be managed for something other than pure total return. Sure, they have noble sounding charters, and in many cases are sorely needed, but let's not kid ourselves. These are not your classic profit maximisers. I've come to think of them as Frankenfunds.

Even just a few years ago, who could have imagined how large and powerful these kinds of capital pools could become. Like Dr Frankenstein's monster, many have been put together in the likeness of other large pools. Some utilise carry or momentum strategies like certain hedge funds (used to) do. And some even seek to diversify their investments like a pension fund would. A few even make direct investments into companies like a private equity fund might. But ever lurking in the background is the spectre of the governments that created them.

The story of Mary Shelley's Frankenstein is really a tale of over-reaching, and therein lies the true risk: the potential for unintended consequences writ large. As governments around the world frantically sweep up the massive amount of private sector leverage that is being shorn during one of the greatest selling panics of the last century, these pools could turn into something very different than their creators intended. One only needs to look back to recent examples like the failure of Lehman Brothers, or the Fannie Mae/

Freddie Mac debacle or even the hastily slapped together guarantee of money market funds in order to see how even the best of intentions can be distorted in short order.

The pendulum has swung: the secular trend of smaller government is over. Those who are looking the other way as the size and scope of government intervention in the global capital markets swells, risk being levelled.

We can debate whether such a shift is theoretically ideal, but now is not the time; the shift is clearly necessary. Fiscal reflation will be of utmost importance over the coming months. As the global economy struggles to get to grips with both an asset deflation and a credit deflation, private sector debt will inexorably be transferred to the public sector.

Survival instinct

During times such as these, certain very human reactions are hard to stifle. Self-preservation moves to the fore, as does the herding instinct. In the US during the 1930s, such instinctive responses were manifested in the ill-conceived Smoot-Hawley Tariff Act, which in turn kicked off a series of retaliatory protectionist responses from other countries...and we all know how that ended. I'm not trying to suggest that these sorts of outcomes are to be expected, but the human condition is never easy to anticipate, especially when it metastasises into a mob.

How managers of these various pools of capital – and their government creators – respond as the credit crisis and global economic slowdown unfolds, is anyone's guess. My sense is that cooler heads will ultimately prevail, but the cyclic cleansing that awaits us will surely test us all. Let's just hope that these Frankenfunds don't end up following the path of their literary antecedent by becoming the agent of their creator's demise.

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