Investment News: Money Morning

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Four Ways to Sidestep the Damage Wall Street's Big Money Movers are Inflicting on Main Street

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Money Morning/The Money Map Report

As the worst financial crisis in recorded market history rocks Wall Street, millions of investors on Main Street keep asking a single question.

When will this end?

The market volatility is unprecedented: Where professional traders once ranked a day as "wild" if we witnessed a 300-point swing, in recent months we've seen 600- and 700-point swings on a regular basis. On Oct. 9, a Thursday, we rode out a record-setting swing of 1,000 points.

That wild backdrop is bad enough. At the same time, however, the major market indices are heading lower – at times with a speed and ferocity never before seen. But the real killer is that there is seemingly nowhere to hide.

This is what Wall Street's Armani Army doesn't tell you about traditional diversification: It doesn't work when everything goes down at once. (The one exception is the specialized inverse investment vehicles that we've repeatedly counseled you to employ precisely to prevent this kind of total freefall. Two examples that we've mentioned numerous times were the **Rydex Inverse S&P 500 Strategy Fund (RYURX)** and the ultra-aggressive "2X" ProShares UltraShort Financials (SKF) exchange-traded funds).

Most noticeably, of course, was last Friday's trading, which began after an overnight bloodbath in the markets overseas. A notice from the CME Group Inc. (CME) that stock index futures contracts were "limit down" – meaning they'd achieved their maximum allowable downward move for U.S. stocks even started trading for the day – didn't help much.

While much of this is commonly explained away as a panic reaction to the news, the reality is that it's primarily a financial panic that's driving this market action lately. And, just in case you recall my comments a few weeks ago about not having seen the hair on fire selling I thought lay ahead, this is exactly what I was referring to.

This time around, ironically, it's not panic from normally flighty retail investors that's causing the markets to go haywire. Instead, it's the big boys that are apparently panicking.

My experience suggests that one or more hedge funds have imploded. Whether by margin call or redemption proceedings is a moot point. We won't know for sure until much later next week when the newspapers finally catch up, but the massive swings we saw in currencies, gold and other commodities are certainly consistent with an unprecedented liquidation – and a forced one at that. Perhaps even more than one.

Long the domain of hedge funds and their uber rich clientele, many hedge funds were over-weighted in these categories in recent months in an attempt to chase performance. Overweighting, in case you're not familiar with the term, means they've made excess investments in those areas. And chasing performance means they're trying to create higher returns by making disproportionately larger bets than they would otherwise. Part of this could be from simply trying to generate larger performance fees, but it could just as easily be attributed to anxious managers placing ever-larger bets in an attempt to make up losses (most hedge funds are under water this year).

Where this gets fund managers in trouble is when they make these over-weighted bets by using leverage. You've probably heard this term a lot lately. In case you don't understand what it really means, let me digress for a moment to explain it. Leveraging up (or simply "levering" to those in the industry) means using borrowed money to control a huge pile of assets that you wouldn't otherwise be able to control.

In recent years, for instance, it wasn't unusual for a hedge fund to lever up 30 to 1, meaning for every $1 dollar they invested they borrowed $29. As a result, a fund with $100 million under management could control $300 million or more of investable assets. I've heard of some funds running 50 to 1, while currency traders routinely run 100 to 1.

While using other people's money dramatically enhances the potential for higher returns, it really enhances the potential for massive losses. Where this gets them into trouble is that a fund running 30 to 1 only has to lose 3% of the $30 worth of equity to get wiped out, as in kaput.

Somewhere along the way, as bad turns to worse and performance deteriorates, a hedge fund's creditors will place a margin call, meaning they want the hedge fund to pony up more collateral or return the money it was loaned. Or, investors will place redemption requests meaning they want out. Either way, this forces the operator of a hedge fund to raise money any way it can.
If a given hedge fund does not have enough cash to meet the margin calls or redemption requests, they have to raise cash by selling assets. And they typically start with the most liquid stuff like gold, currencies and commodities. At first, the sales progression will be orderly, but as I suspect was the case last Friday (and on many big down days recently where chaos ruled), it will rapidly deteriorate into a fire sale where the hedge funds involved dump everything they can at any price just to get out. And that's where their problems affect you and me.

As scores of highly leveraged hedge funds dump billions of dollars worth of holdings at once, they effectively "flood" the markets with whatever the asset is that they are trying to sell. In doing so, they push the values down for the rest of us. For an example, imagine a house in your neighborhood selling for 50% of its appraised value. Upon completion of the sale, all "comparables" in the area, including your own home, will likely take a hit as a result. So it's in everybody's interest to keep prices as high as possible.

But nobody can do that when there are more homes than buyers – even in the best neighborhoods.
So when is it going to stop?

We don't know. No one does. Hedge funds are notoriously secretive in their reporting, so even though there are estimates as to how much they own and (by implication) how much they owe, it's hard to gain perspective on how much leverage is actually being used. Nor do we really know who holds what asset – especially as it relates to potential liquidations.

Over the weekend, rumors were flying that U.S. Federal Reserve examiners are hounding Citadel Investment Group LLC regarding "counterparty risk" and its exposure to debt. Citadel, naturally, vehemently denies this, but lately where there's smoke, there's certainly been the potential for fire.

Then there's Europe. Despite the fact that many Europeans find it fashionable to blame the whole financial-system meltdown on the United States, mounting evidence suggests they may be the biggest hypocrites of all.

Data from the Bank of International Settlements shows that Western European Banks may hold as much as $4.7 trillion in cross-border bank loans to Eastern Europe, Latin America and emerging Asian markets, which means, as ***Bloomberg News*** journalist Tom Cahill described it as "the exposure of continental European banks to a whole set of 'sub-prime' nations in the form the former Communist bloc may be the Achilles heel of the European banking system."

That means that "the elephant in the room is that while public sector debt was held in check by policymakers, private debt as a percentage of GDP exploded, as that was not part of convergence criteria to join the Eurozone."

The fear shared by my professional trading colleagues is that this exposure may trigger a second credit crisis, and more market mayhem similar to that of 1931, when Credit-Anstalt failed and set off a global banking crisis.

If true, that suggests the market drops we've seen so far may be only the tip of the iceberg when it comes to a whole set of "sub-prime" nations in the former Communist Bloc, which has been the stomping grounds for Austrian and German banks in recent years. And it's very personal as millions of adventurous capitalists there took out loans in Swiss francs, U.S. dollars and even Japanese yen – only to find that their repayment terms in local currencies are soaring as each of these currencies has.

Evidently, nobody told them the "carry trade" works in reverse.

Russia is particularly hard hit and the cost of Russian sovereign-debt-insurance using credit default swaps surged 1200 basis points last week, which makes it higher than the cost of Iceland's debt before Götterdammerung hit Reykjavik. According to the ***UK Telegraph***, the foreign debt of the oligarchs ($530 billion) has surpassed Russian foreign reserves.

The bottom line is this: What should we do for now?

That's actually the easy part even though it may not feel like it.

1. If you're retired, take a good hard look at how much money you really need for the next five to 10 years. Talk to your financial advisor and, if needed, take some risk off the table. Move what you need into cash, or such safety-first choices like the American Century Capital Preservation Fund (CPFXX). Do not own anything you would not want to have in your portfolio if the stock markets were to be shut down for a short time.

2. If you're not retired – but are close – and have properly diversified your money to something akin to the 50-40-10 structure we advocate (50% base-builders, 40% global growth and income, 10% speculative), hang in there. And remember, this is exactly why we diversified our holdings in the first place – to get through the rough spots. It's just that this is perhaps the roughest most of us have ever seen.

3. Stick to your plan. Hopefully that includes the disciplined use of trailing stops to capture gains and minimize losses, as well as specialized inverse holdings that profit with each further decline. And don't forget options to hedge existing risks.

4. Above all else, make sure you have a plan – as we do – for re-engaging the markets when the coast is all clear. It may be awhile before we reach that point, but it's important to maintain your upside potential in a down market. When the train leaves the station, the one place you don't want to be is left behind on the platform. Studies like those from Standard & Poor's show that investors can typically make up 80% or more of bear market losses within the first year of a recovery, once that recovery actually arrives.

News and Related Story Links:

- **Wikipedia**:

Futures Contracts.
- **Investopedia**:
  Limit Down.
- **Money Morning Investment Director Commentary**:
  Let Fear Strike Out in This Market – and Not You.
- **Money Morning News**:

  How U.S. Missteps Triggered a Spiral of Worldwide Margin Calls and Deepened the Financial Crisis.
- **Investopedia**:
  Margin Call.
- **Investorwords.com**:
  Counterparty Risk.
- **Reuters**:
  Citadel seeks to end talk of liquidations.
- **Global Economic Analysis Blogspot**:
  Currency Crisis Meltdown in Europe, Japan, and Australia.
- **Wikipedia**:

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- **Investopedia**:
  Carry Trade.
- **Money Morning Credit Crisis Investigation (Part I)**:
  The Real Reason for the Global Financial Crisis…the Story No One's Talking About.
- **Money Morning News Analysis**:

  Sweden Announces Financial Stability Plan as Iceland Prepares for IMF Rescue.

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3. *Comment by Rick* on 28 October 2008:

   Again, this is an interesting and revealing commentary from Keith.

   Exactly because hedge funds along with their managers are notoriously secretive, and that there is yet a West/East European hypocritical "meltdown" to come, the best advice, of the four advisory choices, is number one.

   Stock markets will shut down, for God knows, how long.

4. *Pingback by Credit Check On Credit Speak » Four Ways to Sidestep the Damage Wall Street's Big Money Movers* on 28 October 2008:

   [...] Four Ways to Sidestep the Damage Wall Street's Big Money Movers …counseled you to employ precisely to prevent this kind of total freefall. … Carry Trade. Money Morning Credit Crisis Investigation (Part I): [...]

5. *Comment by Bruce* on 28 October 2008:

   Selling (or buying) by individual investors is no longer a significant force in daily market moves. Individuals increasingly invest through mutual funds and tend to play the market on a daily basis. On the other hand, hedge funds, with their 30-to-1 leverage, are the new "dumb money." They move into asset classes in herds, creating bubbles, and they try to move out together, creating panics. Because they hold so much money, and because they are so leveraged, their moves hit the markets in big ways. And because they are in such competition with each other for big short-term profits, they take the bigger risks, even when they know that the long-term value isn't there.

   The wags can point to a day or two recently when holders of 401k's capitulated and probably moved the market in a big way. Most of the big, panic-driven moves now, however, are generated by the hedge funds–the new dumb money.

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