Money chat

Melting Moments

Economists come in and out of vogue. For a while, in the 1980s and early 1990s Milton Friedman was the darling of the financial sector, but his stock has dwindled in recent times. If economists carried a share price, then one of the most bullish intellectual stocks right now would be little-known economist Hyman Minsky.

Hyman Minsky, who died in 1996, was philosophically against the Friedman view that markets are inherently efficient, and he factored in the human element, observing that creditors become more lax about lending standards during times of stability and the good market conditions gradually give way to too much lending to increasingly ill-prepared borrowers and then instability.

In the Minsky cycle lenders start off strict, lending only to those who can pay principal and interest. With the economy on a roll, lenders open the doors a little wider – to speculative borrowers who can pay interest but must keep rolling the principal into new loans. Finally, the lenders slacken the rules a little more, and start lending to "Ponzi borrowers" those who can't even cover interest let alone principal, and soon start bailing themselves out by selling good assets, or start going under. Economists call this a Minsky Moment, and that's where the markets are right now, with speculators and their sub-prime lenders, finance companies, falling over like a dominoes.

Because these things ripple into the wider economy, Minsky argued that central governments still have a role to play in propping up the financial markets. In Britain we saw this with the Government bailing out Northern Rock bank, and in the USA even George W Bush, a free market man, has stepped in with a bail-out package for his tanking economy.

Every meltdown is a reminder that the market of lenders as well as borrowers needs a reality check regarding risk and return. The problem is that when times are good, the market tends to park its risk aversion at the door. Everything looks attractive; downsides don't seem possible. And so you get readily available money, investment frenzies and eventually retiring farmers, who have spent their whole life building their assets, selling up and investing their whole bundle in those Ponzi borrowers – often developers who have forgotten also that interest rates can go up and markets can go down.

Our job as financial advisers has long been about being the voice of caution, even in bullish times. Our portfolios are not immune from periods of negative market sentiment but we have a number of operating rules that protect clients from Minsky Meltdowns. These include:

- No structured credit products.
- No direct exposure to sub-prime mortgages.
- No finance companies other than UDC.
- We include listed funds which don't have to sell assets to meet withdrawals.
- We invest in investments that pay out income. This provides cash in hand even while the capital value may fall for a time.
- For regular savers, market downturns provide great buying opportunities.
- We remain diversified across asset types (cash, fixed interest, shares and property).

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