



Investing in a Fluid World: What Does the July/August Turmoil Tell us About the Future

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Outline

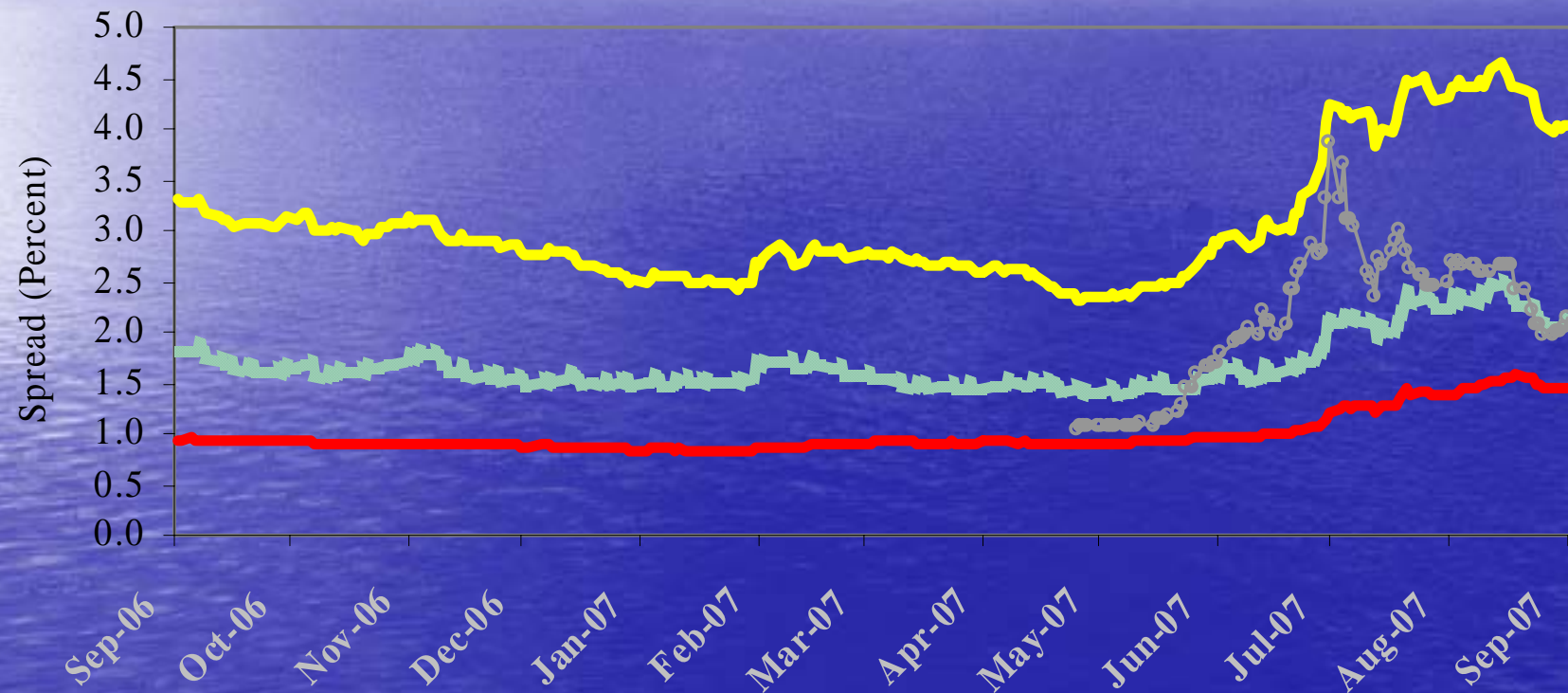
- The Context
- The Underlying Drivers
- General Implications
- Implications for Long-Term Investors
- Concluding Remarks

The Context

July/August Market and Liquidity Disruptions:

- Not just a credit spread widening...
- And not just about tainted asset classes.
- Also about dislocations in areas closest to the Fed window, about liquidity “sudden stops,” and about an erosion in long-standing market parameters

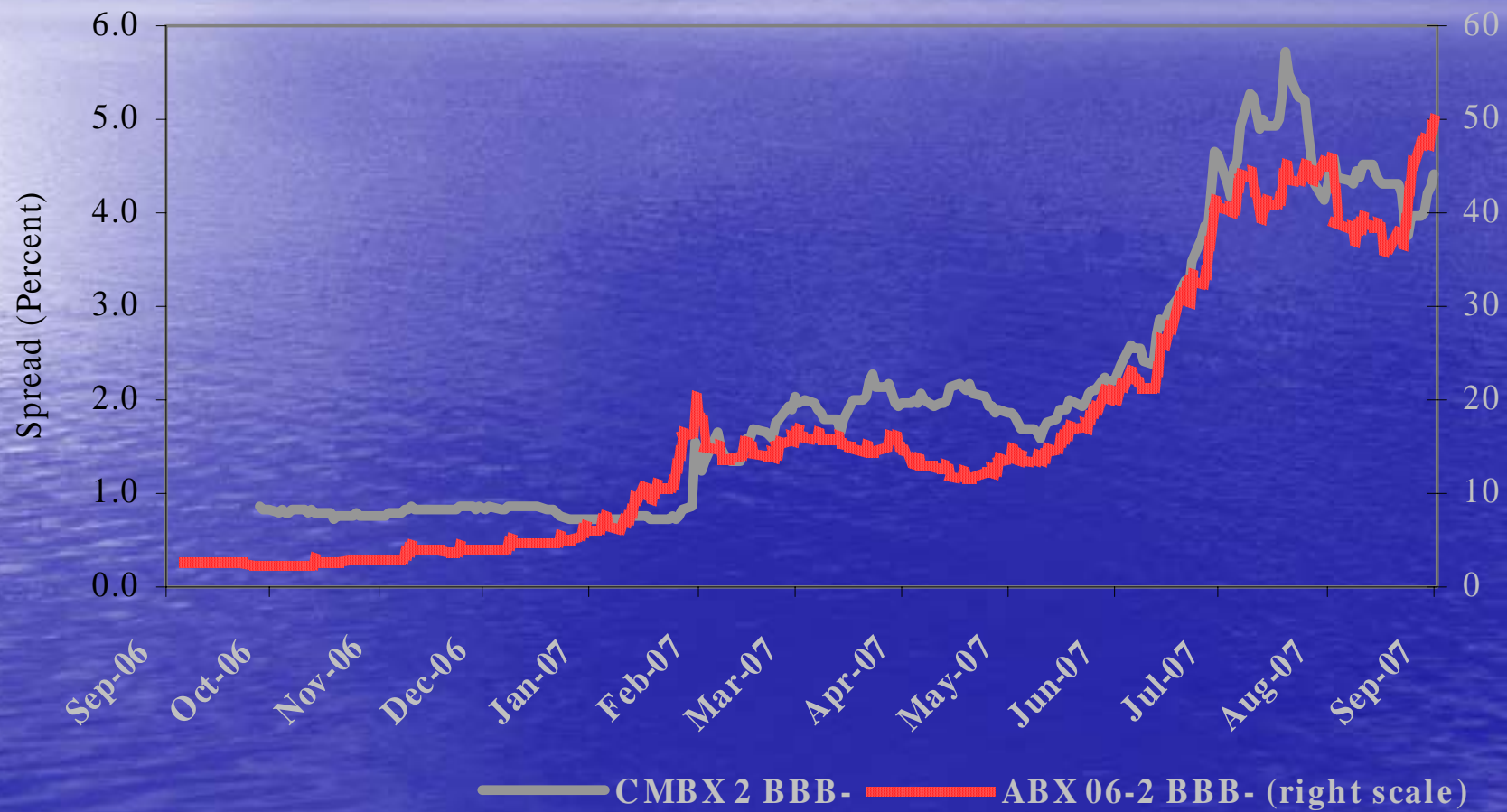
Wider Credit Spreads with Varying Recovery



Source: Lehman, JP Morgan

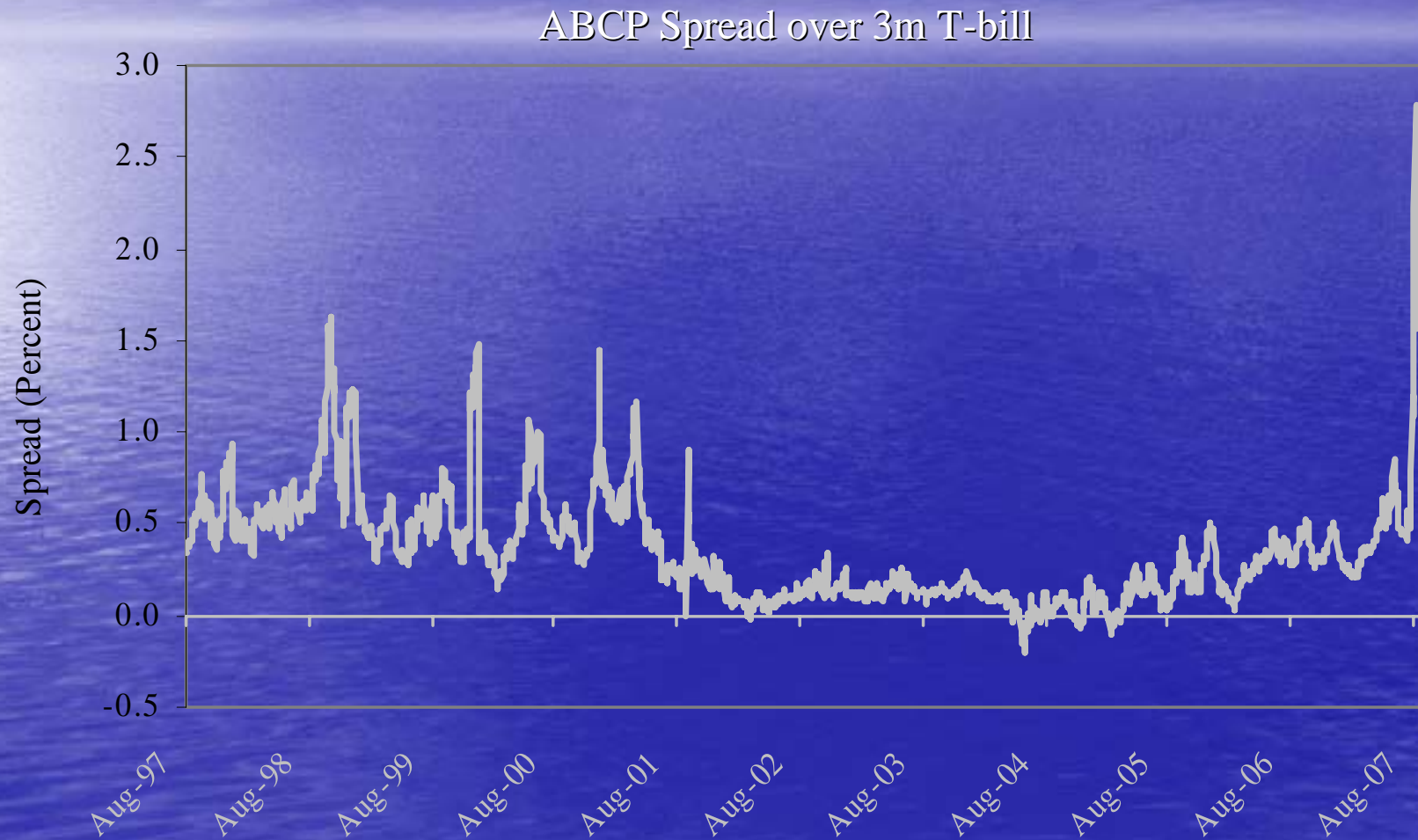
— HY — IG — EMD — LCDX

The Tainted Asset Classes?



Source: JP Morgan

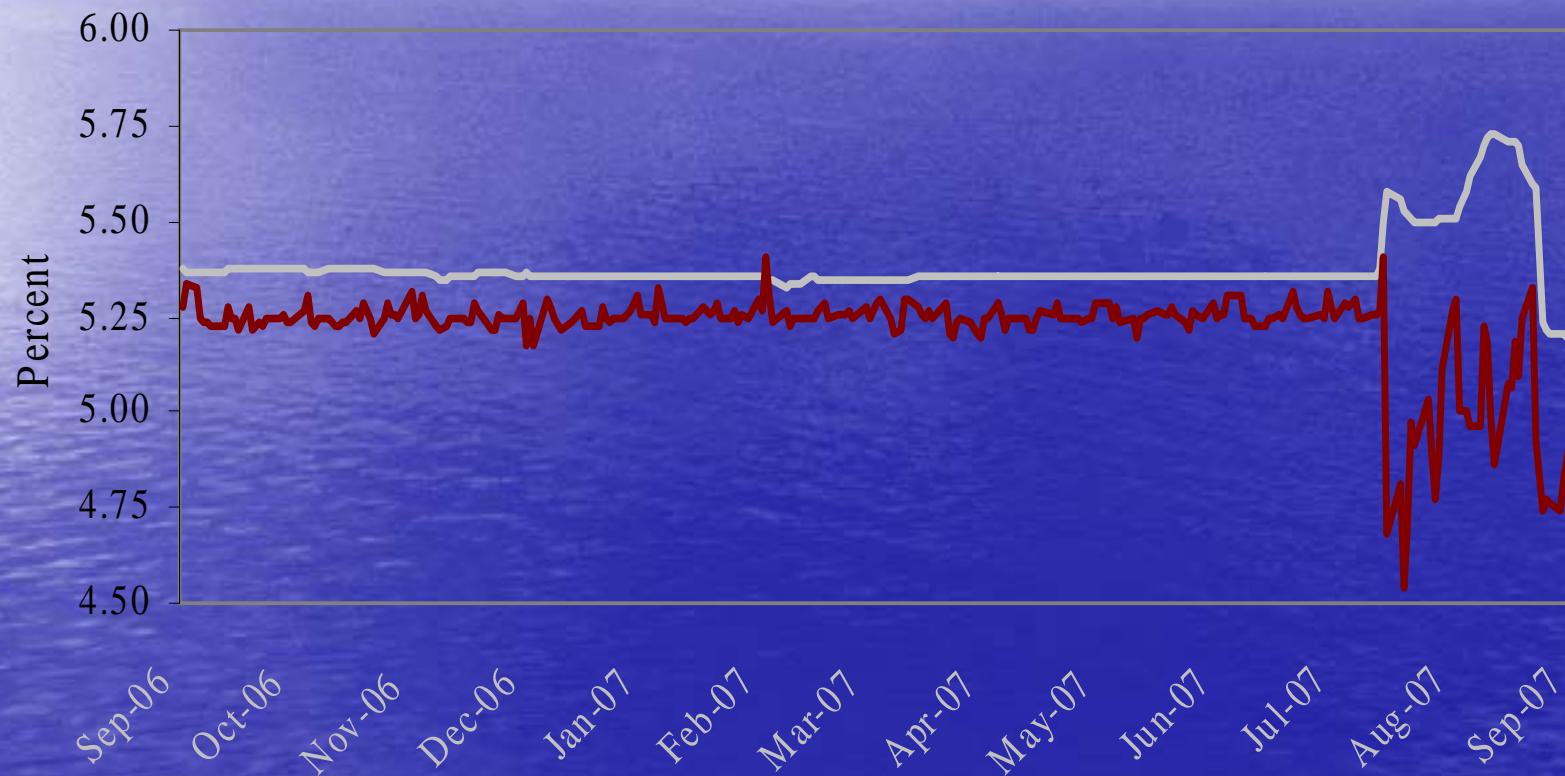
An Historic Dislocation?



Source: Bloomberg, Federal Reserve

Instability at the Nerve Center of the System

Money Market Yields



Source: Bloomberg, Federal Reserve

— 3m Libor

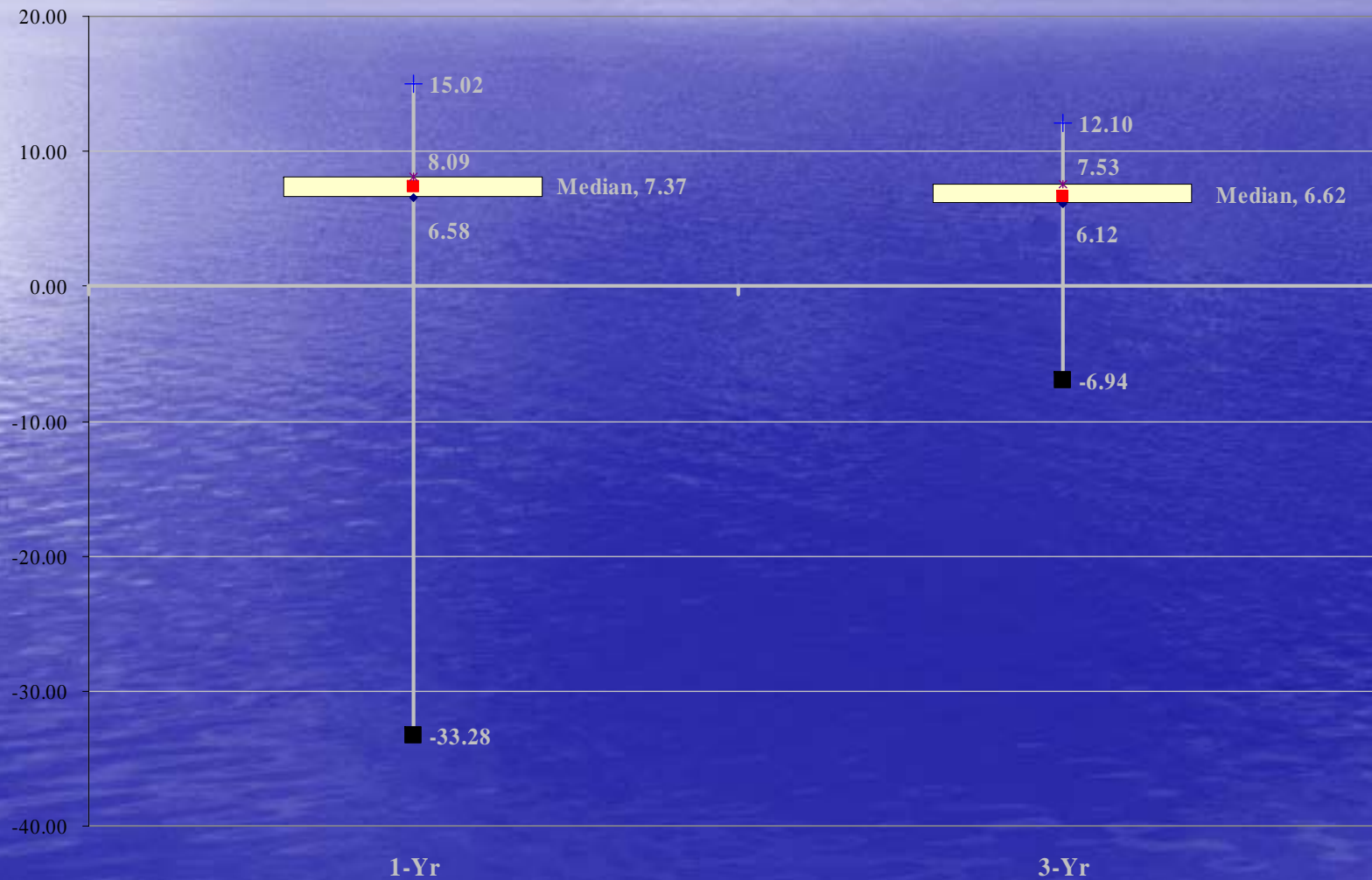
— Fed fund effective rate

Some Immediate Insights from the Dislocation

- Some “parameters” of the market system are now in play
- The banking system no longer acts as a shock absorber
- Greater fragility of some investment constructs
- Performance dispersion to increase
- Its not just about economics and finance; there is also a political dimension

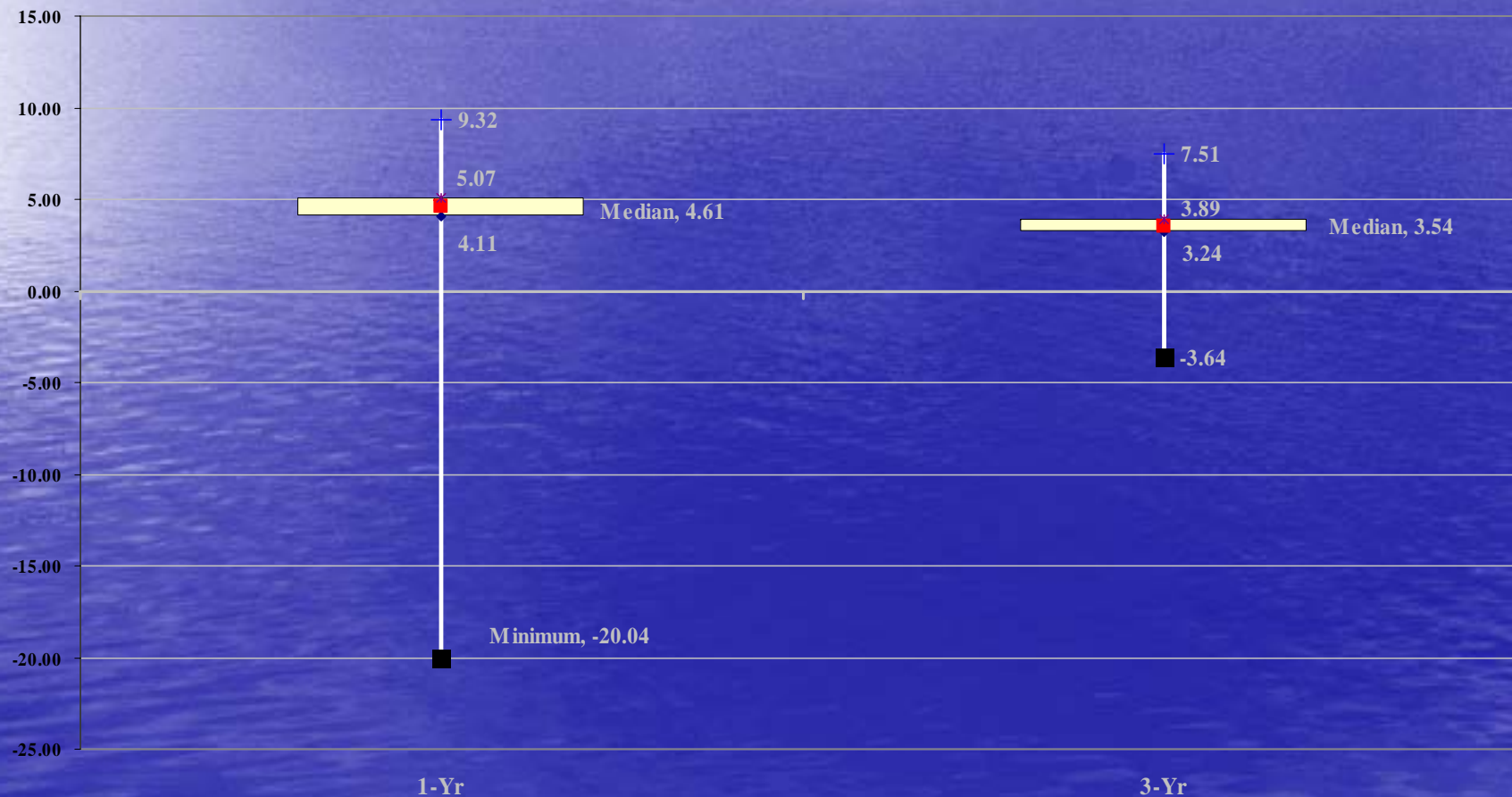
Wider Distribution of Actual Outcomes (1)

Morningstar High Yield Universe



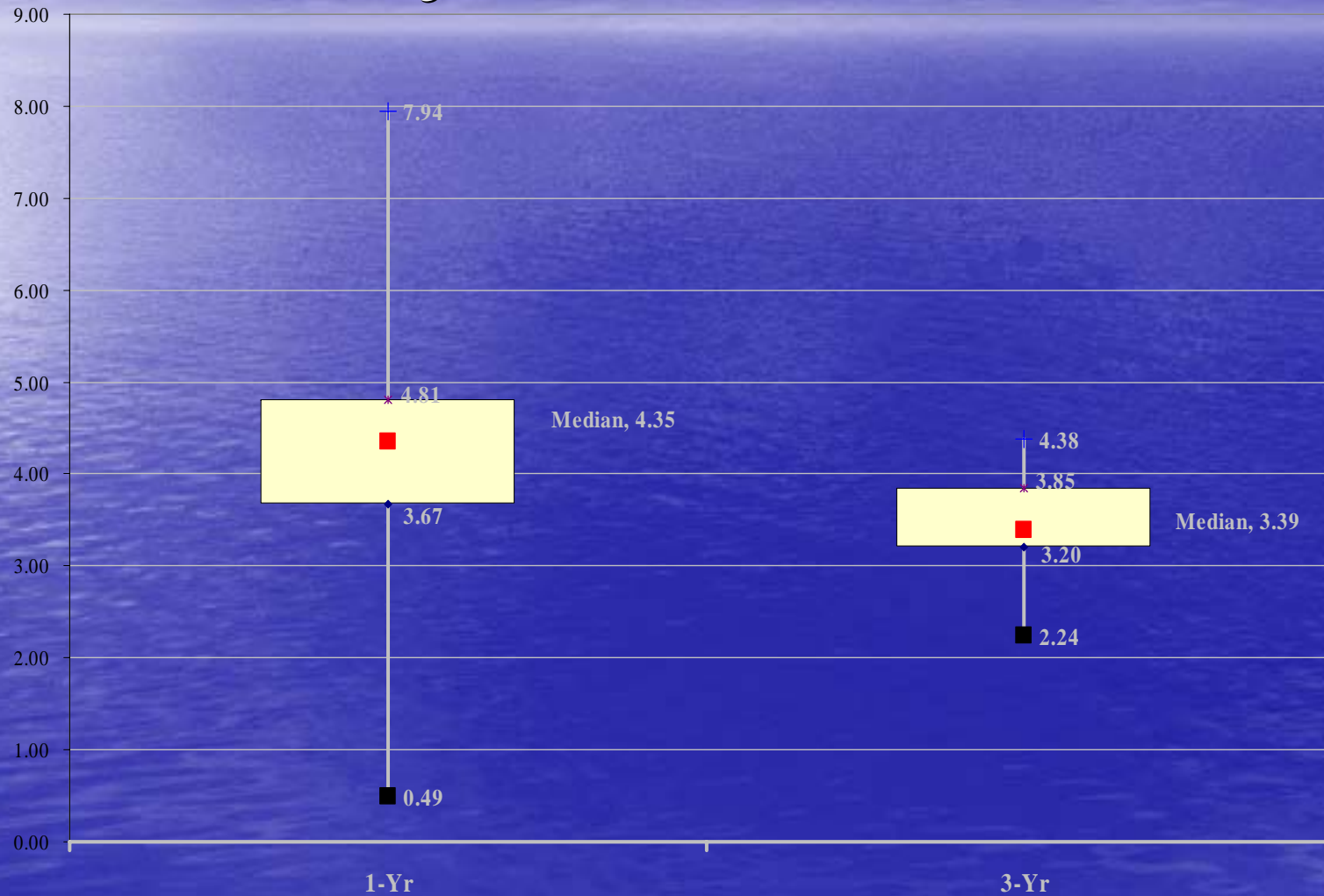
Wider Distribution of Actual Outcomes (2)

Morningstar Intermediate Bond Universe
(Lehman Aggregate Benchmark)



Wider Distribution of Actual Outcomes (3)

Morning Star Inflation Protected Bond Universe



The Secular Context

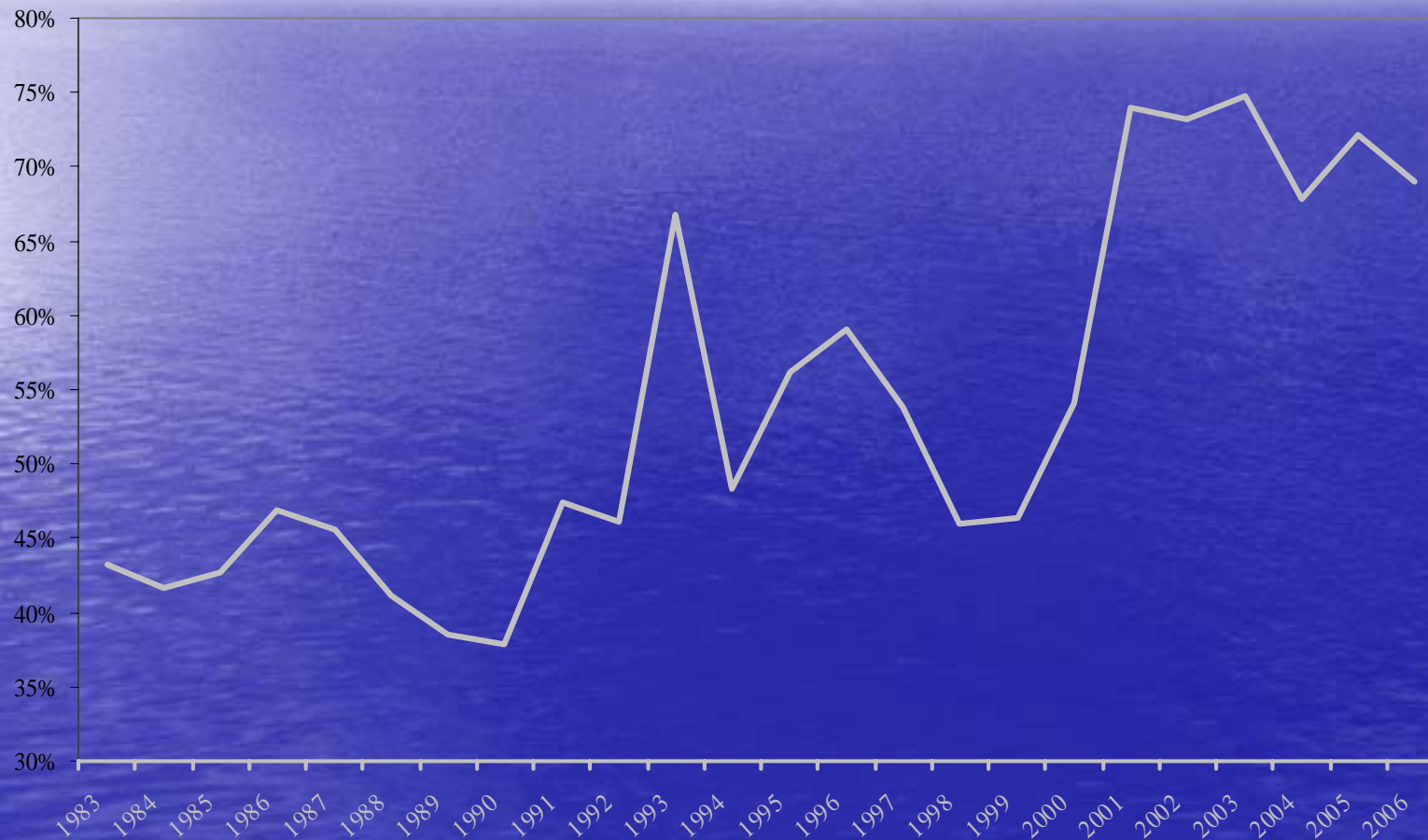
The market turmoil...

Took place in the context of gradual secular handoffs in:

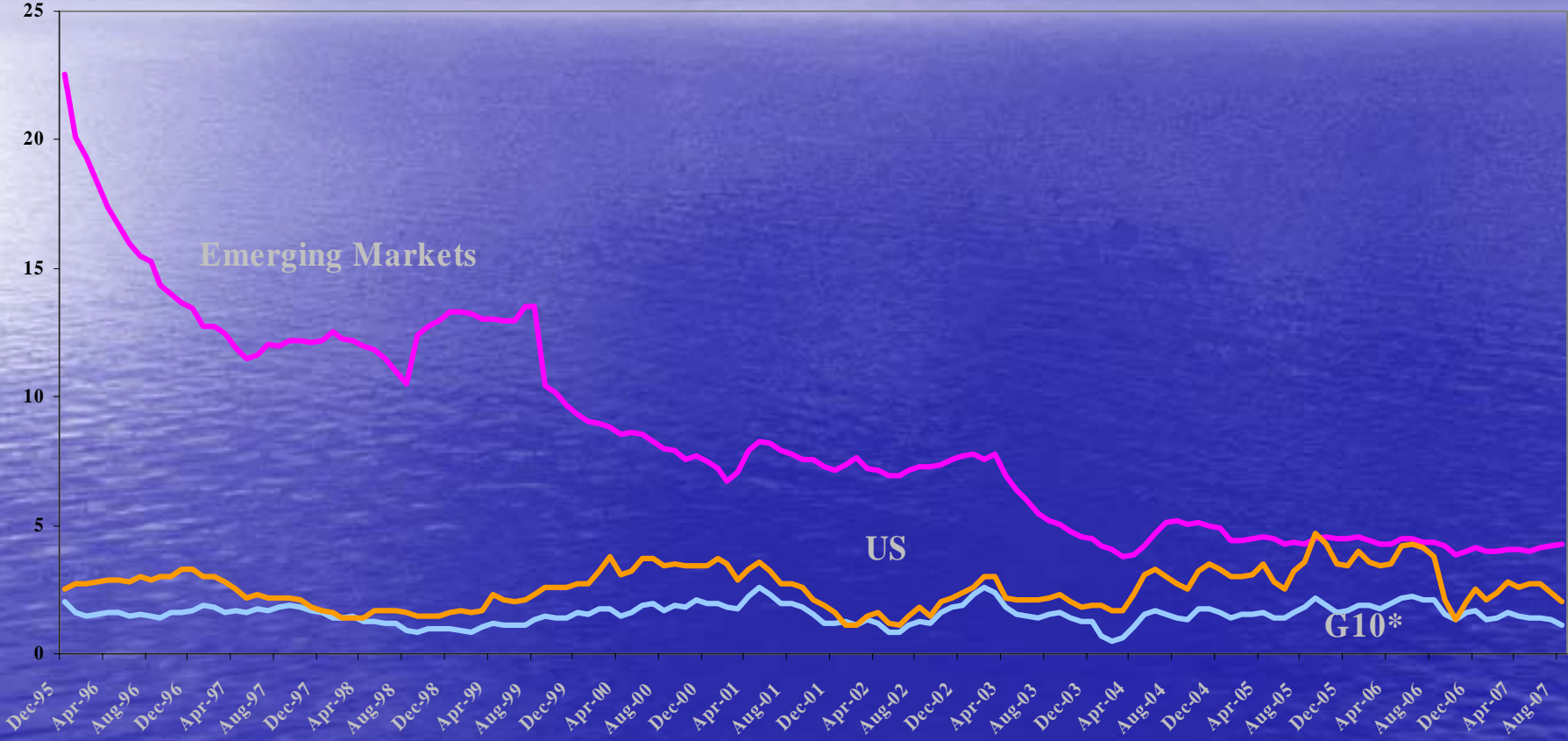
- Growth dynamics
- Inflationary tailwinds/headwinds
- Marginal availability of fresh capital
- Institutional re-alignments

Followed a major “technological shock” that was made possible by the proliferation of derivative-based instruments and products

Emerging markets' contribution to world growth (on a PPP basis)

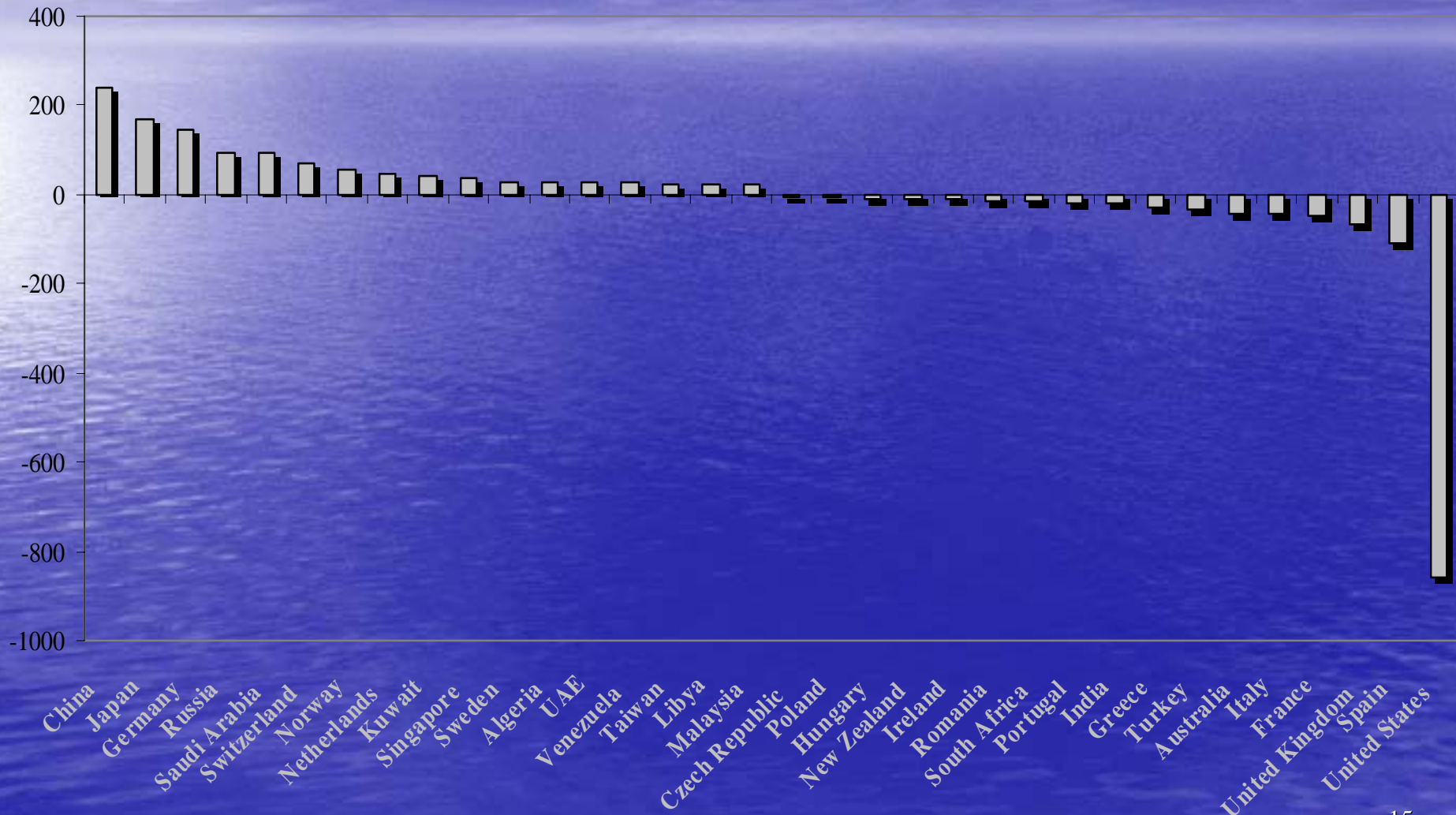


Headline Inflation Rates (y/y)



*Excludes New Zealand and Australia
Source: Bloomberg

Major Current Account Positions (2006 in USD bn)



Source: IMF's World Economic Outlook (April 2007)

Implications

Does the cyclical turmoil change the secular story?

Is the nature of the journey changing?

The Circuit Breakers Held...

- Emerging Policy Responses
- Capital on the sidelines
- Global Growth Robustness

...Re-enforcing the Board Components of the Secular Destination

- More Balanced Global Growth Dynamics
- Dissipation of the Dis-Inflationary Tailwind
- Trade and Reserves Diversification
- Institutional Changes

But the journey will remain bumpy as the now-enabled activities far out-pace the ability of the system to sustain them

- Periodic liquidity “sudden stops”
- Periodically ill-defined balance sheets
- The curse of disruptive technology
- Institutional casualties
- Risk of policy mistakes
- Migration of activities outside the purview of the sophisticated supervisory oversight – private and public

Can the Journey Change the Destination?

A function of

- Duration of the technical dislocation
- Extent of leverage, maturity mis-matches, basis risks
- Policy responses
- Political reaction function

Appropriate Investors Response for Long/term Investors

Best Defined in Terms of

- Specification of Neutral Asset Allocation
- Choice of Appropriate Investment Vehicles
- Designing and implementing Enhanced Risk Management

Asset Allocation

- Defense: less realized diversification per unit of historically-implied diversification
- Offense: focus on market completion

Investment vehicles

In addition to the usual evaluation variables, it is critical to attach higher value to:

- Term financing
- Ability to manage crises

Risk Management

- Enhanced Monitoring
- Greater use of overlays
- Tail insurance programs

Concluding Remarks

- We are in the midst of structural changes that are impacting both the destination and the journey
- The result are fatter right and left tails
- Exploiting the opportunities and managing the exposure to the new configuration of risks require adaptations
- For longer-term investors, this impacts the trio that governs sustained superior investment performance
- The challenges multiply quickly if either the official sector changes its reaction function or the if “catch up” measures cross the delicate line that separates repairs from distortions