Quotidiano Londra
Diffusione: n.d. Lettori: n.d.
FINANCIAL TIMES
Direttore: Lionel Barber
05-OTT-2009
da pag. 11

Prosperity rests on human and social capital

THE FUTURE OF INVESTING

Michael Milken

Amid all the changes since I first went to Wall Street 40 years ago, basic investing principles have not changed at all. Attractive opportunities still await those who do careful research; capital structure still matters; and the best investor is a social scientist who analyses markets from both macro and micro views.

The macro view sees the 21st century defined by global competition for the world's most valuable asset, human capital. Nations build this by strengthening education, healthcare, access to scientific knowledge, opportunities for women and incentives that attract skilled immigrants.

A continuous focus on education is driving the rise of the middle class in Asia. That is one reason Asia's growing economy is expected to reach at least half the world total by 2030, up from less than 30 per cent today.

The return on investment in education is apparent in a comparison of Singapore and Jamaica, former British colonies that once shared many similarities. In the early 1960s, each had a population of 1.6m and almost exactly the same gross domestic product per capita – about 2,200 current US dollars. Then they diverged. Jamaica stuck to agriculture, mining and tourism while Singapore focused on educating its people, who expanded manufacturing capacity and developed advanced technology. Today, Singapore's GDP per capita is nearly $39,000 (€26,800, £24,500) – more than seven times that of Jamaica.

Besides human capital, prosperity also requires social capital. Macro-focused investors look for a strong commitment to private property rights and the rule of law in the areas where a business operates. They ask if workers can aspire to more than a job and realistically dream of being owners. Are companies encouraged not only to take entrepreneurial risk, but also to provide solutions to society's needs?

In contrast to these macro perspectives, the micro view looks at financial markets, which once again this year have shown a remarkable capacity to recover from mistakes by investors, managements and governments. Companies across the ratings spectrum have taken advantage of narrowing spreads and low interest rates to refinance more than $2,000bn of assets in less than nine months. In this cycle, companies that fail to adjust capital structures by selling stock or pushing out debt maturities will miss a big opportunity.

Today's environment mirrors 1973-1977, when markets first demonstrated the ability to heal themselves. The mid-1970s recession created unprecedented problems for financial institutions. Most banks could no longer consistently meet their customers' financing needs. But capital markets offered an alternative through debt obligations and other securities. This allowed new forms of capital structure and assured economic expansion in the 1980s and beyond with reduced involvement by banks, whose role in financing corporate growth has shrunk ever since.

Properly applied and regulated, the market innovations of the 1970s disperse risk and create jobs. The disruption of the past two years was caused by other factors, including unrealistic ratings that failed to reflect underlying credit risk, government encouragement of questionable investments, flawed underwriting practices and deployment of excessive leverage by financial managers who did not see the need for credit research.

As markets rebuild, cash available for investment has grown to record levels. Companies with low capital costs will acquire those with higher costs and create investment opportunities. But markets' future health requires investors to avoid errors that prolong and deepen global downturns. These include inaccurate assumptions that loans against real estate are high-quality assets, interest-rate movements can be predicted, capital structure has little effect on a company's value, emerging-market sovereign debt is without risk and high leverage is best for maximising profit.

Many investors have relied on another fallacy – that rating agencies accurately rate enterprises and securities across different sectors. For much of the 20th century, AA-rated railroad bonds defaulted twice as often as single-B industrials. Recent regulations provided incentives for investment in complex, AAA-rated mortgage-backed securities never close to AAA quality. Ironically, investors will lose more money on AAA credits than on any other rating category.

This illustrates the myth that investments currently in favour are safe. In two 1982 articles – "Nowhere to Go but Down" and "Nowhere to Go but Up" – I made the points that companies with few perceived problems tend to be priced for perfection; and conversely, that it is hard to bankrupt even weak companies, which nearly always rally when investors, management and labour co-operate to sustain them. Like more than 99 per cent of companies, these enterprises do not carry investment-grade ratings. But non-investment-grade companies create virtually all net new employment.

Finally, as I said in an academic paper nearly 40 years ago, investors need to understand that capital-structure risk should vary inversely with business risk. Companies with volatile revenue streams must avoid leverage and build their capital structure with substantially more equity than debt. Some should have little or no debt.

If we are to keep from repeating mistakes that exacerbate boom-and-bust cycles, we will have to define the lessons of history more accurately. The ongoing strength of capitalism depends on it.

The writer is chairman of the Milken Institute in Santa Monica, California


Prosperity rests on human and social capital
An American polity blinded by rage
Diverging deficits could fracture the eurozone