

Spotlight on Panics and Systemic Risk

If a couple needs to sell a house because of divorce, they will probably sell it at a decent price. If hordes of homeowners all put their houses on the market simultaneously, prices will sink. This is the difference between normal market conditions and a financial panic.

The financial markets are susceptible to contagion and toxicity, just as people are. When a large number of investors are exposed to something that suddenly goes awry, they all try to sell their assets at the same time. This massive selling scares away buyers, and creates a wave of selling and sharply falling prices. As the remaining investors see prices plummeting, many of them may decide to sell their holdings because they fear further price drops. This is called a panic.

A classic panic is a run on a bank. We saw this in 2007 with Northern Rock, in England. Banks do not hold cash to cover 100% of their deposits. Instead, they lend it out. Their business is matching borrowers with savers. If something causes a bank's depositors to lose faith in the bank and to fear that they will not be able to get their money out, they hurry to withdraw their funds while they can. As other depositors see the doubts mounting, they too get in line to withdraw their funds. Because no bank will be able to satisfy the demands of all depositors simultaneously, panic can cause a bank to fail, even if its balance sheet was perfectly sound to start with.

A panic can also center on a particular asset. When Bear Stearns was on the edge of collapse, its stock went from \$62.30 to \$30 in four days. On what turned out to be its final day before the Fed's emergency intervention, it fell 47%. The Fed stepped in because it feared what would happen to the financial system as a whole if Bear Stearns failed.

The Fed had reason for concern. If a panic is limited to a particular asset or institution, the financial system as a whole will remain intact. However, if there is some common theme that joins the toxic asset or institution to others, if many depend on the failed entity for their value, or if there is one significant holder of a toxic asset who has obligations to many other market participants, then the panic can spread to the entire financial system. We call this systemic risk. When this happens, people and institutions start selling any assets that they can, prices fall across the board, and liquidity dries up. This is when leverage kicks in and amplifies the damage. Because levered players have to repay their lenders quickly, they sell whatever assets they can into a declining market, thus further pushing down prices. We saw this in September 2008, with the collapse of Lehman Brothers, and again in October 2008 when the House of Representatives failed to pass the TARP legislation.

You could say that systemic risk exposes the dangers of volatility, illiquidity, and leverage all together. The more interconnected the global financial system becomes, and the more risk and capital become concentrated in a few large institutions, the more the system becomes susceptible to wholesale panic.

Even if individual investors limit their market risk, try to avoid assets that might become illiquid, and avoid leverage entirely, they may still be susceptible to panics and systemic risk. While we at Contango do our best to anticipate systemic collapses, we cannot foresee every one, nor can we completely shield our investors from the ravages of a panic. What we can do, however, is to emphasize the benefits of diversification and the benefits of being a long-term investor, which include the ability to bounce back over time after panics. Anyone who sees a meltdown around every corner will never take on any risk, and will never be in a position to benefit from asset growth. Those who fear to leave home become hermits.

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