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## *Stash Flow* **Huge Flood of Capital to Invest Spurs World-Wide Risk Taking**

**Corporate and Foreign Savings Chase Assets, Driving Prices Up, Keeping Returns Low  
'A Global Game of Chicken'**

By **GREG IP and MARK WHITEHOUSE** Staff Reporters of THE WALL STREET JOURNAL *November 3, 2005; Page A1*

A week after Hurricane Katrina, a defaulted loan backed by aging tugboats and barges in coastal Alabama came up for sale. Mooring Financial Corp., a firm that buys troubled loans at a discount, was interested, but couldn't determine how well the boats had survived the hurricane, or even whether their cash-starved owner had kept up the insurance on them. So Mooring bid just 50 to 55 cents on the dollar, figuring that was generous for such a dicey deal.

Instead, it lost out to a bidder who offered about 10 cents more on the dollar, says the Virginia firm's president, John Jacquemin. "We would have won this...one to two years ago," he says. "But in the current market, there are few, if any, 'ugly stepchildren' that fail to draw aggressive bids."

It's a sign of a major global investment phenomenon: There's an unprecedented wave of capital flowing around the world, with all of its owners anxiously searching for a better return. World pension, insurance and mutual funds have \$46 trillion at their disposal, up almost a third from 2000. In the same period global central-bank reserves have doubled to \$4 trillion, and other gauges of available capital have risen as well. ([See related story](#)<sup>1</sup>.) Meanwhile, world central banks have kept short-term interest rates low, even after the Federal Reserve's latest quarter-point boost. That means investors who put their cash in safe money-market paper can net only a modest margin above inflation.

The result is that global investors are diving into a wide range of riskier assets: emerging countries' stocks and bonds; real estate and real-estate-backed debt; commodity funds; fine art; private-equity funds, which

buy stakes in nonpublic companies; and the investment contracts called derivatives, including a kind structured to permit the sophisticated to take huge bond risks.

For good measure, many investors use today's low interest rates to borrow money to amplify their bets. This "leverage," in effect, thus enlarges the already overflowing pool of investment capital. As these markets draw more investors, whose buying pushes up their price, prospects rise that a reversal could cause widespread pain.

Where does this global flood of cash come from? Ben Bernanke, the economist just nominated to head the Fed, last March identified what he called a "global savings glut," which he said helps explain the relatively low level of long-term inflation-adjusted interest rates in the world.



**AWASH IN  
CASH**  
Cheap Money,  
Growing Risks

• [Taking Measure of the World's Cash Hoard<sup>2</sup>](#)

That there should be such a glut when U.S. consumers save none of their current income and their federal government borrows heavily might seem paradoxical. But plenty of others do save and accumulate cash to invest, including U.S. corporations. Companies' profits are near record levels, yet their expansion plans are muted, partly a hangover from the expansion excesses of the late-1990s stock-market bubble. So they have lots of money seeking a home.

Abroad, meanwhile, many families' saving habits are the mirror image of Americans' free-spending ways. European and Japanese workers save far bigger shares of their incomes, and Chinese households a stunning 25%. In all, China is expected to have about \$116 billion to invest abroad this year, much of which goes into U.S. bonds.

Meanwhile, the steep price rises on oil and many raw materials in the past three years have fattened the purses of commodity-producing countries. Exports by Russia, a big oil producer, are likely to exceed imports by \$102 billion this year, the International Monetary Fund estimates. About 60% of the Russian central bank's \$163 billion in foreign reserves are invested in assets denominated in U.S. dollars.

"People talk about a wall of money everywhere," says Peter Fisher, a former Federal Reserve and Treasury official who's now a managing director at BlackRock, a New York investment company. "Bankers talk about too much money chasing deals. Private-equity funds talk of money chasing them. And buyers of corporate and asset-backed debt seem to come at the bond market from all directions."

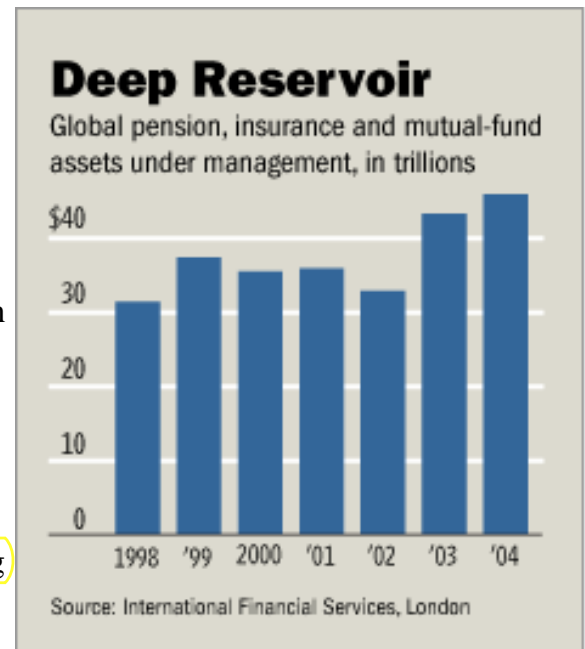
### Low 'Risk Premium'

Policy makers increasingly see worrisome consequences of this global cash surplus. As the price of an asset rises, the income it throws off -- a stock's dividend, a bond's coupon, a building's rent -- automatically

declines as a percentage of the asset's value. This means investors are demanding less compensation than usual for taking on the risk inherent in owning the assets. In the lingo of economics, the "risk premium" is low today.

There are some sound reasons why it should be low. World economic growth has been unusually stable and predictable for several years. The U.S. economy grew at a 3.8% annual rate in the third quarter, the eighth straight quarter at about that pace -- the least volatile two-year stretch of growth on record. U.S. inflation did hit a 14-year high in September, but it remains low when energy prices are excluded. And the financial system hasn't seen the threat of a serious blowup since the 1998 Russian default and collapse of the Long Term Capital Management hedge fund, or private investment pool.

But the concern is that, historically, very low risk premiums often presage a broad market decline that pushes down stock prices and pushes up what everyone must pay to borrow, hurting economic growth. "History has not dealt kindly with the aftermath of protracted periods of low risk premiums," Fed Chairman Alan Greenspan noted in August.



As investors pile into riskier assets and their prices rise, they generate impressive returns for those who own them and attract still more investors. Cautious money managers who play it safe and stay on the sidelines run the risk of showing embarrassing low returns, and losing clients. Most choose to stay in the game.

Investors' quest for higher returns can present a dangerous quandary, says Jim Sarni, who invests for pension funds and insurance companies at a firm called Payden & Rygel in Los Angeles. "It makes you continue to invest in higher-yield instruments despite the fact that spreads are narrow" -- that is, their return above safe instruments is small. "So it becomes this vicious cycle," Mr. Sarni says. "It is a global game of chicken."

There are signs in the past month or two that investors are becoming a bit more risk-averse. Yields on long-term Treasury bonds have begun to rise in response to the Fed's continuing campaign to raise the rates it controls, short-term ones. Yields on riskier bonds have risen even further.

## Stock Valuations

In addition, risk premiums as reflected in the U.S. stock market, while low, are not as ridiculously low as they became in 2000 at the peak of the technology-driven stock bubble -- perhaps because of memories of fortunes lost when that bubble burst. One measure of stock investors' appetite for risk is how much they'll pay for a dollar of earnings -- that is, the price-earnings multiple. The higher the multiple, the more willing they are to accept risk. That multiple for the Standard & Poor's 500-stock index averaged 14 from 1945 to 1996, then soared to over 30 during the tech and telecom bubble. Today, after a 2003 rally from post-bubble lows, it's 19, still pricey by historic standards.

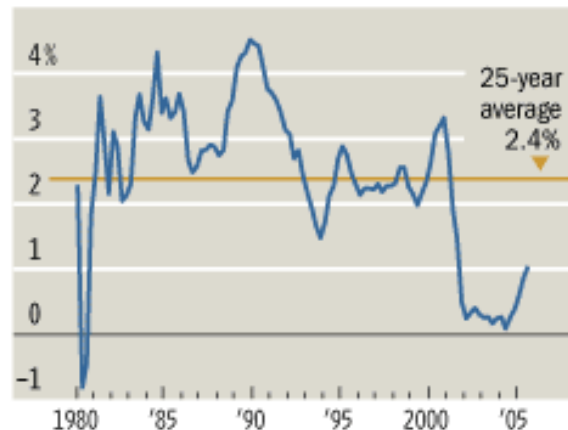
## Hungry for Yield

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"Remember when stocks looked like a sure thing to most people?" says Ed Keon, strategist at Prudential Securities.

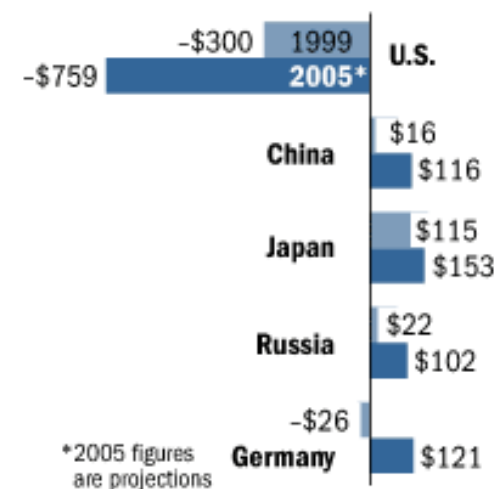
### Easy Money

Short-term interest rates don't offer much above inflation. Average of industrial-country central banks' rates, minus inflation (excluding food and energy).



### Out of Balance

While the U.S. borrows heavily abroad, many countries have big trade surpluses and are eager to lend. Balances on current account (trade plus investment income), in billions.



### Little Compensation for Risk

Investors have driven down the yields on risky corporate (high yield) and emerging-markets bonds. Spreads over comparable Treasuries, in percentage points.



"Now that place has been taken by real estate, and many people now see stocks as inherently risky and dangerous."

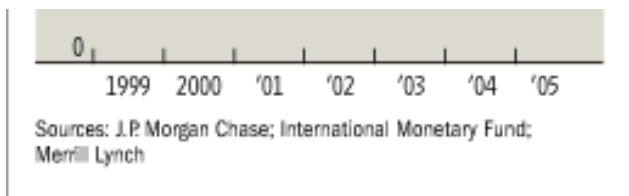
But in many other countries, money has been flooding into shares and local stock markets have boomed. And U.S. private-equity funds, which either acquire nonpublic businesses or buy public ones and take them private, have garnered more than \$80 billion from investors this year. That beats a full-year record set during the boom five years ago. The risk here: Putting money in these funds basically entails betting on a big payoff somewhere down the road. Investors can suffer big losses if they try to get out early, or if the underlying businesses perform poorly.

In July, when some private-equity firms decided to buy a financial-services firm called Sungard Data Systems, they decided to help finance the deal by issuing \$2 billion of "junk" -- below investment grade -- bonds yielding more than 9%. Yield-hungry investors clamored to get some, and placed bids for four times as many of the bonds as the private-equity firms wanted to sell. One bidder, Lord Abbett in Jersey City, N.J., says it was able to buy less than half as many of the high-yield bonds as it wanted.

Says Gerd Häusler, the International Monetary fund's director of international capital markets: "The search for yield has been the defining factor in financial markets for roughly the last two years."

Pension funds have a tradition of conservative investing in blue-chip stocks and top-rated bonds. But the \$18 billion Iowa Public Employees' Retirement System holds over \$800 million of junk bonds, more than double what it held in 1999. "There's absolutely no reward for investing in government bonds," says Michael Fitzgerald, the state treasurer. "When interest rates are this low, we're looking for more risk." Money has poured into junk bonds in recent years, bringing yields on them to a very narrow 3.5 percentage points above those on super-safe Treasury bonds; three years ago, this spread was 10 points.

Meanwhile, the 3.2 million employees of academic and research institutions who invest their pension money through money manager TIAA-CREF have sunk \$8.9 billion of its \$350 billion cache into a corporate real-estate fund. Among other things, it owns a San Francisco skyscraper and a large Washington, D.C., office building.



That real-estate allocation is up from zero a decade ago. It's been "one of our runaway hits," says John Cerra, a TIAA-CREF portfolio manager, who calls the real-estate investing a matter of prudent diversification.

## Slice of Risk

Wall Street has responded to the thirst for better returns with creative new instruments. Among the most popular are structures known as "synthetic collateralized debt obligations," or synthetic CDOs. Thanks to the magic of financial engineering, they can provide income from a pool of corporate bonds without anyone's needing to actually purchase bonds. The sponsor divvies up the synthetic CDO in slices that represent varying exposures to the risk of losses if any of the companies default. Then the sponsor sells investors the various pieces, according to their tolerance for risk and appetite for higher returns.

But as with other investments, when many are clamoring to buy, returns get squeezed. In a measure of today's high demand, a conservative slice of a typical synthetic CDO now pays only about 0.25 percentage point more than the benchmark rate at which banks lend to one another. Two years ago, comparable synthetic CDOs paid about 1.45 percentage points more than the benchmark rate.

One investor is a U.S. unit of Germany's Commerzbank. Its CDO holdings have risen to \$500 million from nothing in three years. And though demand has driven the yield way down, "it's still better than in Germany," says Joachim Doepp, general manager of the U.S. unit.

Indeed, short-term rates are only 2% in the countries whose currency is the euro. They're just over 1% in China -- and near zero in Japan.

The plethora of investment capital has helped alter the climate, too, for a time-honored investment strategy known as "the carry trade." In this, an investor borrows money at low short-term rates and puts it into longer-term bonds that pay higher interest, pocketing the difference. This strategy, a mainstay business of big banks, pays off best when there's a wide gap between the short- and long-term rates. It gets dicier when the gap dwindles.

These days, the gap is shrinking. The Fed is moving short-term rates up, of course. But, apparently owing to demand from investors with a lot of money to deploy, long-term rates have stayed stubbornly low.

"It's about the worst combination of things," says Jon Schotz, chief investment officer of a hedge fund in Santa Monica, Calif., called Saybrook Capital LLC. He says his short-term borrowing rate has doubled over the past year, to 2.5%, while the yield on the higher-risk long-term municipal bonds he buys has fallen to about 5.7% from about 6.5%. Mr. Schotz says he has begun to borrow more while shifting his investments into less-risky bonds. But the additional use of borrowed money, or leverage, also would mean bigger losses if asset prices went against him. "I usually pray a lot," he jokes. "I can really find religion on this."

## What Could Go Wrong

Some economists and policy makers say that risk premiums are bound to rise, which means many asset prices, from corporate bonds to real estate, would likely fall. No one is sure what the trigger would be. It's

often something unexpected that investors haven't incorporated in their forecasts. It could be that although many companies today are highly profitable and able to service their debts with little trouble, rising oil prices could hold back global growth and impair corporate creditworthiness. Witness the recent bankruptcy filings of auto-parts maker Delphi Corp., Northwest Airlines and Delta Air Lines, all of which burned holders of their securities.

If the world's central banks boost short-term interest rates more sharply than expected to ward off inflation, investors might start selling some of their riskier assets in favor of newly attractive short-term instruments. The Fed has recently stepped up its anti-inflation rhetoric, and the European and Japanese central banks have indicated they may raise interest rates in the coming year.

At the same time, corporations might revive expansion plans and become big borrowers again, pushing up long-term interest rates. Rising risk premiums, and thus falling asset prices, could then become self-reinforcing as leveraged investors unwind their positions to limit losses, driving asset prices down further and triggering still more selling.

Under this scenario, the pain could spread to Main Street if newly risk-averse lenders demanded higher rates for mortgages. Rapidly rising mortgage rates could weaken housing prices. "Significantly lower asset prices would erode the large net worth of highly indebted households," says the IMF's Mr. Häusler. "They would cut back on their consumption, especially if their savings rate is zero or close to zero, reinforcing downward economic and financial trends."

Yet the evidence to date is that a rise from today's low risk premiums is more likely to be gradual and easily absorbed by the financial markets and national economies. When the debt of General Motors Corp. and Ford Motor Co. was downgraded to "junk" last spring, the moves caused pain among many hedge funds, but no broader contagion.

Mr. Häusler suggests that pension funds' growing ownership of risky assets might even make such assets less vulnerable to sudden changes of sentiment. The reason is that the funds have long investment horizons, and might not dump assets as readily as other investors would.

Similarly, the explosive growth in hedge funds in the past several years -- they number more than 8,000 now -- may mean there are more sophisticated investors willing to jump in and buy if asset prices fall sharply. "I don't see a systemic crisis," Mr. Häusler says. "As long as the speed and extent of the widening [in risk premiums] is within reasonable boundaries, we should welcome it."

**Write to** Greg Ip at [greg.ip@wsj.com](mailto:greg.ip@wsj.com)<sup>3</sup> and Mark Whitehouse at [mark.whitehouse@wsj.com](mailto:mark.whitehouse@wsj.com)<sup>4</sup>

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