Capitalism will always cook up new products

Investment bankers have much in common with celebrity chefs. A good cook adjusts the ingredients in a recipe to alter the flavour and improve the taste. Similarly, a top-notch investment banker alters the composition of the assets in a financial instrument or a securities portfolio in order to suit the risk preferences of his clients.

Some customers want the stodgy but safe performance of cash, others enjoy the spice of volatility that comes with mining stocks, yet others appreciate a sauce of extra return from derivatives. The art of investment management is to mix and match, to dice and marinade, the so-called "asset classes" – cash, bonds, equities, property and so on – into structures that are appetising to particular investors.

But high finance differs from *haute cuisine* in at least two ways. The first is that bankers are better paid than chefs, and the second is that the customers have more difficulty understanding the complexity and variety of investment products than they do in interpreting restaurant menus. Moreover, whereas a meal is digested once, an investment product can be recycled many times.

As a general rule, a fee or commission of some sort is due to someone in the financial sector when such recycling takes place. The temptation to proliferate artificial rounds of transactions, and to take fees on every round, is obvious. Indeed, the creation of artificial fee-generating vehicles seems to be the main cause of the current shake-up in financial markets.

Excessive and inappropriate fees in the hedge-fund industry must undoubtedly take much of the blame. Whereas most investment products take between 0·5 per cent and 1·5 per cent a year of assets under management, the norm in the hedge fund world is two per cent plus 20 per cent of the return above a certain "benchmark" figure. So the managers have an incentive to take too much risk in order to deliver the excess return.

One method is to borrow from the banks, in the expectation that the return on the new assets will be higher than the rate of interest owed to the banks. The borrowing – or the "gearing" as it is known technically – will then deliver the desired excess return. Needless to

Tim Congdon

say, the banks charge fees for arranging loans to hedge funds, just as they charge fees for any other loan. To add to the fun, some banks have formed hedge fund subsidiaries that work alongside long-established investment management businesses.

The hedge fund subsidiaries charge fees, while the investment management businesses put client monies into the in-house hedge fund products and charge fees for that, too. All this may sound incestuous and even corrupt, but in some cases the hedge funds' assets consist of loans bought from banks. (Alternatively, the assets may be issues of "commercial paper", which look remarkably similar to bank loans.) The process of converting bank loans into marketable securities goes by the grand name of "securitisation" and involves – yes, you guessed – yet another round of fees.

Have you lost track of the ultimate saver and his or her final investment? If you have, there is no shame in it. The unfortunate truth is that many of the supposed professionals in the financial sector have also lost their way. The merry-go-round of fee-collecting was splendid for the banks as long as all the borrowers paid up. But over the past few years, too much of the genuine non-financial lending was to low-quality or sub-prime borrowers, particularly in America. As some of these sub-prime borrowers have failed to pay, the hedge funds have lost money and the banks have asked for their loans back. But the hedge funds can repay the loans only by selling assets. Worse, if several hedge funds are in the same situation and they are obliged to sell the same sort of asset simultaneously, the price of that asset falls. There are more hedge fund losses and, in another round of liquidation, the banks call in more loans.

Is this "the end of capitalism"? Of course not. While the interactions between banks and hedge funds have been an abuse, and surprisingly large sums seem to have been lost, it is important to keep these problems in perspective. If $300 billion of client money has been lost, the damage has been mostly to high-risk hedge fund investors. It is very unlikely that any major bank is in danger. Barclays was rumoured to have lost "several hundred million dollars", but compare that with its total shareholder equity of almost £30 billion.

British share prices have fallen by about 10 per cent from the peak, but they are still 50 per cent higher than they were five years ago and roughly 50 times higher than 50 years ago. The sub-prime crisis may leave a bad taste in the mouth, but capitalism will keep on cooking up new products and new ideas, and making us all richer for centuries to come.

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