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Insight: No Immunity From Policy Action

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Not long ago, the question of how the actions of national authorities – and the US Federal Reserve in particular – impacted on their investment decisions would get a range of replies from investors. Some observed that their decisions were unaffected; others cited the old mantra that “you should never fight the Fed”.

Today, few investors would cling to these simple views. Most correctly realize the importance of a more dynamic approach that recognizes that well-intentioned official actions are fundamentally altering risk-reward propositions in several markets. Not even relative-value investors, who have historically prided themselves on never having to take a directional view on the economy and policies, are immune to the impact of policy actions.

It is not just that the Fed has been pushed into a more activist role by an unprecedented financial crisis that has morphed into a global economic calamity. And it is not just about interest rates being cut to zero.

It is also about the adoption by the Fed (and other government agencies such as the Treasury) of unorthodox measures that target specific sectors, individual institutions and – importantly within these two – precise parts of the capital structure.

The surge in activism is not a matter of choice for the authorities; it is a necessity. The response seeks to contain the economic and financial hurricane that, especially after Lehman's collapse, has become truly global in nature and indiscriminate in impact. It is about trying to activate new circuit breakers to limit the damage to employment, productivity and welfare in 2009 and beyond.

There is no easy way to do this. The breakdown in traditional policy transmission mechanisms is so severe that the authorities have, in the words of Fed chairman Ben Bernanke, to sidestep the banking system. This involves their becoming directly involved in markets and in institutions deemed of systemic importance. And increasingly, Fed action is part of a broader government response that does, and should, combine the resources of multiple agencies.

Investors will differ on whether this is being done in the right way. But they should all agree that such public-sector involvement inevitably affects the effectiveness of traditional investment strategies. There is no question about the willingness of

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governments in many countries to take bold actions, including full and partial nationalizations. The uncertainty relates to their effectiveness.

In this new world, investors should pay particular attention to three issues.

First, the authorities are forced to make difficult choices about which markets and, more controversially, which institutions to support. By definition, these choices are not commercially driven. As a result, the notion of a level playing field for markets is giving way to the more random influence of discretionary decisions.

Second, given the speed and highly contagious nature of the crisis, the authorities do not have the luxury of a master plan that specifies ex ante the extent and sequencing of market interventions. Instead, they seek to respond quickly to severe market failures.

Third, when they intervene, the authorities must also seek to protect taxpayers. As such, they will subordinate somebody in the capital structure – the equity holders for sure. In some very exceptional cases, holders of preferred and senior securities could also be vulnerable.

Where does this leave investors? As my colleague Paul McCulley likes to say, only a thin line separates courage from stupidity. Investors should position their portfolios predominantly under the umbrella of government support rather than outside it; they should follow government actions rather than pre-empt them; and they should focus primarily on the senior parts of the capital structure.

The time will come when the authorities will return to being just the referees of markets. For now, they are both referees and players. Investors should adjust their investment approaches accordingly.

The writer is chief executive of PIMCO, and author of [When Markets Collide: Investment Strategies for the Age of Global Economic Change](#), winner of the 2008 FT/Goldman Sachs business book of the year award.

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