
‘Too Big to Fail’ Brings Investors Unstuck

I recently read an engrossing instalment of [The HCM Market Letter](#), an American subscription newsletter written by the outspoken Michael Lewitt. The last page of the 1 April issue included the depressing share price graphs of five once-giant companies that have since been bailed out by the US Government – as Lewitt put it, five ‘quasi-public companies being kept on life support by the government trailing little stubs of public stock behind them like turds in the dust’.

Although I’ve been following the news closely over the past few years, it still shocked me to reflect on the fact that the world’s once largest bank, Citigroup, its once largest automaker, General Motors, its once largest insurance business, AIG, and the two American mortgage giants, Fannie Mae and Freddie Mac, now attracted such a metaphor.

For years, these businesses had been considered ‘too big to fail’, an assumption that gave stockmarket investors a high degree of comfort. That assumption of being too big to fail proved spot on, with the US government diving in with assistance at almost every turn of this financial crisis (although General Motors may prove the exception). Yet it’s meant diddly-squat for equity investors in these five companies who’ve lost substantially everything they had invested.

So what went wrong? The answer, I think, is that many investors unknowingly were making a second assumption, one that proved dead wrong. They correctly assumed that the US government wouldn’t let these businesses sink, that they were too important to the financial system and the economy to not bail out. But investors then made the assumption that this implicit guarantee made the equity of these companies safe, or at least much safer than most stocks.

Of course, it all seems so obvious with hindsight. Why should the government put a cent of its money at risk until after the equity holders have been completely wiped out? But this second, malignant assumption was so commonplace, and it caught so many investors out, that it’s worth considering what other assumptions investors are making today that they may regret tomorrow.

Too big to fail Down Under

Terms such as ‘too big to fail’ have been used for a long time in association with Australia’s big four banks. Bankers regularly referred to the ‘implicit government guarantee’ of our banks, a guarantee that [became explicit](#) late last year. It was once a commonly held belief that this implicit guarantee made the shares of the big four banks ‘safe’. This assumption has certainly taken a beating in the past year, a result of the American experience, but we propose taking it out back and shooting it. When push comes to shove, governments care about depositors, not shareholders, and rightfully so.

Telstra’s magnificent monopoly

This is another assumption that's taken a knock in recent years. But many shareholders still consider [Telstra](#)'s local loop an unbreakable monopoly. But it is already subject to gradual erosion – as customers move to wireless – and potentially revolutionary change from new technologies. The situation is much the same for hearing implant maker [Cochlear](#), a company that is likely to maintain its dominant global market share *unless* an unexpected new technology completely revolutionises the business.

Property may go sideways but it won't fall significantly

There are many reasons why property prices, particularly residential property, might not fall over the coming years. But most of those reasons – such as 'everyone needs a roof over their head' and 'they're not building any more land' – also held true in the United States and United Kingdom prior to their bubbles bursting. We don't rule out the possibility that Australia might be different. But we think it's important to realise that there's also a *possibility* that Australian residential property will fall significantly over the coming years, and we don't want to make any investments that are overly reliant on the assumption of invincibility holding true. That leads us to a related assumption.

Australian banks are the strongest in the world

This is a relatively new one, but it's gained a lot of ground amongst investors and politicians, and has come about because our banks have proven quite resilient during the financial crisis. It's natural to draw the conclusion that this was the result of brilliant management or regulatory oversight. But we'd also suggest it is heavily reliant on the previous assumption, that property prices won't fall significantly. Australian property has held up much better than in other western nations, which has helped our banks greatly. If this situation changes our banks might not look so comparably strong.

Consciously or otherwise, stockmarket investors make a great many assumptions in their attempts to separate investment wheat from chaff. Unavoidably, as [Tatts Group](#) and [Tabcorp](#) shareholders have painfully learned, many will prove false. But we can do a lot to protect ourselves by thinking through those big, commonly held beliefs – they're the ones that seem to do the most damage.