

## Six Lessons From the Financial Crisis

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### Lessons To Be Learned From the Financial Crisis or “Won’t Get Fooled Again”

Change it had to come  
We knew it all along  
We were liberated from the fall that's all  
But the world looks just the same  
And history ain't changed  
'Cause the banners, they all flown in the last war

We don't get fooled again  
Don't get fooled again  
No, no!

Pete Townsend, The Who

### Background

- The financial markets have been under a dark cloud over the last few years. Market turmoil has taken a toll on investors, cast doubt on our financial system, postponed retirements, called into question the ethics of top corporate leaders and turned homeowners into renters.
- Somewhere in the midst of all that is a silver lining that consists of lessons that we should learn or perhaps need to relearn.

### Our View

- Lesson 1  
Applying leverage to an investment that offers only a small return (Treasury Notes for example) doesn't change it into a good idea. Treasury Notes are inflation sensitive as well as interest rate sensitive, so although they are among the most conservative of investments, they can still deliver surprises. More volatile, less conservative investments can deliver even greater surprises. Leverage magnifies those surprises. Of course not all leverage is bad.

There are good examples of leverage like putting down 20% down on a home purchase and borrowing 80% (leverage). Which if you are in housing market today, be prepared to put some “skin” in into the purchase.

- Lesson 2  
Don't believe everything an analyst tells you. A big part of the 2007-2009 debacle was the lack of due diligence done by investors, even the most sophisticated ones. It's important to dig deep and ask questions and understand the assumptions behind an analyst's opinion. We need to get out our old Latin books and look up the meaning of *Caveat Emptor*.
- Lesson 3  
This time isn't different. President Harry Truman stated “The only thing new in this world is the history that you don't know.” Subprime mortgages are subprime mortgages and no matter how much financial engineering is done; the facts don't change, sub-prime won't turn into prime regardless of how it is packaged. We saw similar engineering in the 1980s when junk bonds were used instead of mortgages. Bubbles follow the same path

over and over. The future holds more bubbles. Behavioral impediments such as over-optimism, a focus on the short term and having a self-serving bias can lead an investor into serious trouble.

- Lesson 4  
Be patient. According to the New York Stock Exchange (NYSE), the average holding period for a stock listed on the NYSE is only 6 months. Equities are designed to be a long-term asset and investors need to embrace this concept. Sometimes the best course of action is to do absolutely nothing. In the aftermath of the most recession, some of the most dominant global companies and brands go on sale. Patient investors buy them. This characterization is reflected in the current market environment. Stocks are selling at what we believe are attractive valuations.
- Lesson 5  
Investor sentiment is important. Valuation matters, yet sentiment plays a critical role. Warren Buffet stated *“Occasional outbreaks of those two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics is equally unpredictable, both as to duration and degree. Therefore we never try to anticipate the arrival or departure of either. We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.”* In a study done by Baker & Wurgler certain groups of stocks do better when sentiment was high or low. In general when sentiment was low buying junk stocks generated the best returns (2009 was a good example). When sentiment was high, buying high-quality stocks was the best strategy. We think the markets look similar today, and may offer similar opportunities. Fear can be blinding, cheap stocks only look so cheap in hindsight. Investors have to look forward. Quality companies with solid balance sheets and growth prospects don't vanish in a bear market they just become a better investment opportunity.
- Lesson 6  
Be prepared is the Boy Scout motto yet many investors are not. The future is uncertain and unpredictable. Accordingly, investors should consider an adequate cash reserve for the unknown. A cash cushion is very comforting even if it doesn't yield anything. The cash reserve should be a minimum of 6 months living expenses and could be as much as 2 years of living expenses. With a reserve investors may be in a better position to ride out unexpected market downturns or exogenous events (The Deep Water Horizon Offshore Platform Blowout) and not overreact into making market timing decisions. Making financial decisions when emotions are running high can lead to trouble. Martin Luther King Jr. put anxious emotions into perspective by expressing, “Normal fear protects us; abnormal fear paralyzes us.”

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