# Crash course in meltdowns

Anthony Keane | National Features | December 04, 2011 11:30pm

Take our crash course in financial disasters.

**FINANCIAL disasters have cost millions of investors billions of dollars over the past 25 years. Your Money examines five of the big ones and the lessons we can learn from them.**

1987 STOCK MARKET TUMBLE

IN AN era of high-flying entrepreneurs who crashed and burned, the share market surged between January and October 1987, only to quickly halve. Many experts blamed the crash on computer trading systems for blindly selling stocks as markets fell, while others said international foreign exchange issues played a role. There was a mountain of speculative buying in the lead-up to the crash.

LESSONS LEARNT:

Senior investment analyst at Prime Value Asset Management, Fiona Clark, says there was too much speculation in the lead-up to the crash.

"The lesson was about the herd mentality. Don't go with the herd," she says.

"People started investing for the first time as shares became more available, but you have to have realistic expectations."

Clark says 1987 was the first big crash for many investors and taught people that you need to manage downside risk.

"Think about investing as a delicate balance between wealth creation and wealth preservation," she says.

This often means avoiding risky shares altogether, or selling down when things get too hot.

"It's a bit like pulling out the weeds," she says. "You can plant flowers which may take a long time to grow, or you can pull out the weeds, which is easier."

Steven Dooley, the head of research for foreign trading platform ForexCT, says 1987 showed there are no half measures with the share market.


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"The market's either leaping over itself in enthusiasm and excitement, or lying on the bed in the foetal position," he says.

"1987 was the era of Bondy and Skase (entrepeneurs Alan Bond and Christopher Skase). It was classic financial engineering and people were becoming risk-takers.

"If someone in a really expensive suit shows you a great new concept that's going to take your money, that's an alarm bell."

SUBPRIME MORTGAGE AND GLOBAL FINANCIAL CRISES

CHEAP interest rates in the US and Britain in the 2000s fuelled an investment and housing boom where people with no realistic chance of repaying loans were given huge sums of borrowed money, on the belief property prices would always rise. Investment banks packaged these dodgy loans and sold them to investors around the world. Then the wheels fell off property prices, massive US businesses collapsed and the global financial crisis put the world into recession in 2008-09. Aussie shares suffered their second-biggest fall in history, down 55 per cent.

LESSONS LEARNT:

Clark says many investors were caught out as complex debt structures within companies caused havoc when credit markets froze.

"The average investor didn't know what was going on," she says. "People had started investing expecting a 20 per cent plus return because that was what they had seen over the previous four years, but you have to be realistic."Head of research for ForexCT Stephen Dooley says before the GFC, there was a global mania about property.

"Everyone was crazy for it," he says. "But property doesn't always go up. People think it can't happen to us or it can't happen to Australia."When you hear people say it's different this time, it isn't."

He says unlike shares, there is no electronic scoreboard for property, so it is harder to measure when it strays too far from fair value."The GFC, like most financial crises, was propagated on the overblown claims of property growth and assumed values," Dooley says.

"The magical thinking that homes are worth far more than people are prepared to pay and the alleged capital gain almost never takes into account the money that was put into the property to achieve the sale price."

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STORM FINANCIAL COLLAPSE

QUEENSLAND'S Storm Financial was one of the highest-profile collapses in Australia during the GFC, taking down the life savings of many retirees with it. Storm's clients borrowed heavily often using their homes as security to invest in the share market. It also charged high fees. Storm's original business success flowed from the share market boom during the mid-2000s, but collapsed spectacularly when the market plunged more than 50 per cent.

LESSONS LEARNT:

Prescott Securities's Peter Hickey says Storm's business model was flawed because it relied on share markets continuing to rise. It also urged inappropriately high gearing levels and a lack of investment diversification.

"The combination of these factors meant the business was unable to survive a full business cycle," he says.

Anyone investing must make sure they understand what they are paying in terms of upfront and ongoing fees.

"A quality financial adviser should not be charging fees of more than 1 per cent plus GST per annum," he says.

"All up, fees for advice, platform administration and fund managers should be not much more than 2 per cent plus GST."

Advisers say people should always aim to invest in quality companies with good management, conservative debt levels and a solid and growing dividend stream paid out from company profits not borrowings.

"The bottom line is that you need to be comfortable with what you are investing in, understand your assets and the strategy that you are employing," Hickey says.

However, good judgment comes from experience, Wealth for Life's Rex Whitford says.

"Unfortunately a lot of experience comes from bad judgment," he says.

"Find a professional who has already seen the experience of others and can help you make a good judgment."

## MADOFF PONZI SCHEME

HE WAS rich, respected and attracted wealthy investors clamouring to get him to "invest" their money. But Bernard "Bernie" Madoff was really running a giant Ponzi scheme for more than 20 years, which came unstuck during the GFC and resulted in losses to investors estimated at $18 billion. A Ponzi scheme is where investors are lured in by high returns that are paid from their own money or from subsequent investors, rather than profits from investments. Its success relies on new investors joining and keeping the money tap running.

LESSONS LEARNT:

Prescott Securities principal and financial adviser Peter Hickey says it's vital to know what you are investing in.

"If you don't understand what the advisers are doing and where your money is going, proceed with caution," he says.

"In Madoff's scheme, many investors relied on the word of non-professional investors." Wealth for Life's Rex Whitford says investors should ask as many questions as possible until they are satisfied.

"Sometimes the smartest guys in the room are not the smartest they're just crooks," he says.

"If you ask for information on your investments and do not get a straight answer, ask more questions. If you still do not get a straight answer, demand your money back."

Prime Value's Fiona Clark believes investors should only deal with institutions or people of the highest calibre.

"If somebody says they can make you some easy money, approach that person with caution," she says.

"Nothing comes from luck. It's all a matter of hard work, time and effort."

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## TECH WRECK

BETWEEN 1995 and 2000, investors and speculators piled into new internet-based companies, many generating little or no income. Rising interest rates caused many companies to collapse without ever making a profit. Our resources-based economy was seen as boring and old world during the dotcom boom, but this helped us escape much of the carnage.

LESSONS LEARNT:

"I do remember everyone telling me that this bubble was different and dotcom companies did not need to have earnings to justify their valuation," Wealth For Life Financial Planning principal Rex Whitford says.

"As it turns out, they did need to have earnings."

ForexCT head of research Stephen Dooley says the key lesson was a simple one: "Every bubble pops".

"Be comfortable taking assets off the table at some point. Most people never have an exit strategy," he says.

"Where are we comfortable with how much money we have made? It's a difficult question to answer."

Prescott Securities principal and financial adviser Peter Hickey says a vital lesson is to invest in companies with an established history and a consistent earnings stream.

"Find businesses that work in a market that is not highly competitive, or offer a product where consumer demand is known and will always be consistent," Hickey says.

Prime Value's Fiona Clark says the biggest lesson from the dotcom bubble is to "understand what you are investing in".

"Avoid anything with a complex debt or ownership structure," she says.

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