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On Failures of Information Flows

Peter L. Bernstein

As luck would have it, I made a good call last February on the troubles accumulating in the financial system: "The rational response to low expected returns is to withdraw and wait until expected returns are higher. That response ... seems to have gone out of fashion. Today's re-sponse is ... to underestimate risks taken.... Many [derivatives] are right off the drawing boards and have never been tested in turbulent markets with real counterparties and high and widespread volatility. Here I do worry."

Like others of my ilk, I spoke glittering generalities but failed to touch on the specifics: the crisis cooking in the housing sector. By the time I wrote those words, housing prices had been declining, although gently, for a full year, while housing starts were down 30%. I was far from alone in ignoring these threatening developments. Indeed, fed funds were still at 5.25%. I would venture to guess that a search of the financial press in February 2007 would have yielded at most a couple of dozen references to something called "subprime mortgages." A search for "CDO" would have produced even fewer references. For once we had a dearth of information instead of an overload.

Only a year later, everybody is an expert on the disasters in the subprime mortgage mar-kets, the interstices of the bond markets, the shattered virtues of high-yield bonds, the abrupt re-versal in the tight spreads between corporate and Treasury bond yields, and the complex nature and sad histories of SIVs, CDOs, and other even more obscure three-letter financial instruments. The popular press and television talk show hosts calmly discuss these matters with the kind of acumen you would expect from a conclave of MBA alumni. Once upon a time, Richard Nixon proclaimed, "We are all Keynesians now!" With equal ease, today's commentators are all derivatives and mortgage market experts now.

If the erudite analyses we read today about the nature and risks of these financial instruments had been as widely circulated a year ago or even further back, including in my own material, the impact of the recent crisis on the financial and property markets might have been less ominous. Just a few nice articles in the popular press—and especially in the "how to invest" kinds of columns and the high-speed TV commentaries—might have spared millions of people terrible pain. An article on why home prices could not go up forever and the possible consequences of a reversal in prices would have been simple to present, but it could have changed the course of people's lives.

I am unaware of any such line of analysis in the popular press prior to the summer of 2007, and recall only a few warnings among the more sophisticated financial observers on my reading list, notably Robert Shiller. Two major institutional investor conferences I attended last spring were silent on these developments.

But once the news broke, explanations of what had happened burst forth in a flood. Everybody seemed suddenly to be an expert on housing, mortgage lending, yield spreads, and the complexities of financial engineering.

I do not expect anyone to have predicted the actual sequence of events. Nobody ever knows for sure what the future holds. But we must recognize the profound differences in value between after-the-fact explanations of what has happened and why it happened versus explanations in advance of the risks, or what might happen and what kinds of adverse outcomes are possible.

Back in August 2005, I invented the word postcasting to characterize explanations of what has happened as though the outcome were an inexorable outcome from an earlier set of conditions. What we have seen here is postcasting par excellence.