Who's afraid of thinking for themselves on investments?

By Aline van Duyn in New York
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"A woman must have money and a room of her own to write," said Virginia Woolf in 1928 in *A Room of One's Own*, which has since become a feminist classic. Her point applies much more broadly than to the struggle for women's rights. Indeed, any human being needs space and money to be creative. The idea can be extended further: people need to be able to think independently.

The economic system is now plagued by a lack of independent or critical thinking, and the role this absence has played in the global financial crisis is becoming clearer by the day. The idea that professional investors apply rigorous independent analysis to everything they do has already taken a harsh beating this year. Some do, but many do not.

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That the slicing and dicing of loans could turn a bad risk into a rock-solid investment was the false belief that has already wiped out $1,000bn dollars of value on mortgage-backed securities and other structured deals. It is no longer controversial, even at securitisation industry forums, to state that an over-reliance on credit ratings bred complacency.

The scandal surrounding Bernard Madoff's alleged giant **$50bn Ponzi scheme** is another blow to the belief there are a lot of smart investors out there.

Once Mr Madoff got the seal of approval in the form of recommendations from respected investors, it appears others blindly followed. Some of the most revered hedge funds, as well as investors specialising in allocating money to hedge funds, appear to have lost billions invested in Mr Madoff.

The willingness to invest in something your peers appear happy with is not dissimilar to the impulse to buy securities on the back of strong credit ratings. Herd behaviour again highlights the lack of independent thought or critical enquiry – which even experts paid to apply such analysis have succumbed to in a long boom. It confirms again the importance of psychology on investment decisions.

Campbell Harvey, a professor at Duke University Fuqua School of Business, has worked for consultants who vet funds. A while ago – he believes it was about six years but cannot remember the exact date – he was asked to judge Mr Madoff's fund. He says he rejected it at the first round.

"Things are discarded for different reasons," Mr Harvey told me. He said in the case of the Madoff fund, he looked at it very briefly and rejected it out of hand because the consistent returns on equity investments it touted "did not make any sense". He said it was not credible because the risk of fluctuating returns which are common in equity investments (stocks are riskier than other types of capital-like bonds) had apparently completely disappeared.

"To me this looks like a basic failure of the due diligence process," he said.

The degree to which investors can be relied upon to think independently in future is now the core question that will determine how the financial system is restructured.

Faith in "self-regulation" – requiring a large degree of critical analysis – has clearly evaporated. If anything, the Madoff scandal makes it even more likely reliance on third parties – from rating agencies to bond insurers to feeder funds – rather than investors' own judgment will be discouraged and prohibited.

These questions will now be examined by a **new batch of Obama-appointed regulators** .

The issue is that, once you remove a common reference point such as credit ratings that allow for a degree of commoditisation, the potential scale of the financial system shrinks dramatically.

If every transaction has to be individually vetted, and complexity disappears because there are few common reference points, lending and borrowing will revert to a more local and smaller business. The effect of regulation would be the opposite of the boom in credit that followed the deregulation of recent decades.

Towards the end *A Room of One's Own*, Ms Woolf says it is time for a peroration – the concluding part of a discourse. Her's seems an appropriate call to responsible investors – as well as lax regulators: "I should implore you to remember your responsibilities, to be higher, more spiritual; I should remind you how much depends on you, and what an influence you can exert upon the future."

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