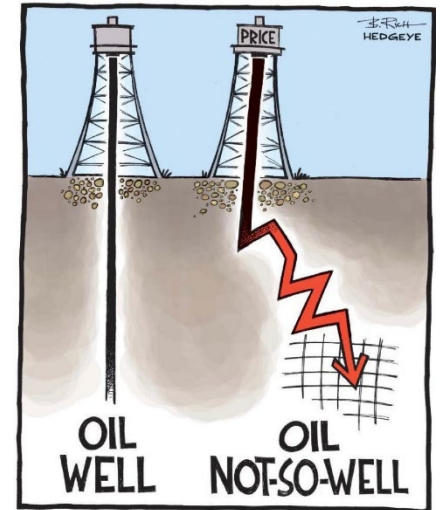


## When Investment Assets Turn Into Liabilities

With most of the world turned upside down, should it have really surprised anyone that the futures price of oil fell through zero for the very first time? The truth is that given the massive fall away of demand, storage has become saturated.

Because of this no one wanted to own the WTI May futures contract, which would have meant taking delivery and then trying to store it. The price going negative was the buyer's way of telling the sellers, *"listen you need to pay me to take this oil off your hands because, it's going to cost me even more in storage costs."*

So, a case of too much supply relative to declining demand as we try and navigate through the coronavirus global shutdown.



## Negative Yields on Bonds

We have seen a similar thing play out with certain global bonds, where for some years now, especially across European countries – but coming to a country near you – lenders have agreed to loan out 1000 euros in order to receive back say 960 euros after 10 years.

At face value this does not make sense, because the lender is the one with the capital to invest. Where the future carries uncertainty – the borrower could default, inflation may rise – lending should demand some form of compensation above the zero bound. Otherwise why lend out at all.

Again, in a normally functioning free market system this should not happen. But where interest rates have been artificially suppressed, assets have become loans with an annual liability.

## Other Assets / Investments That Could Suddenly Turn Into A Liability

There are a few risk aspects that investors should always be cognisant of, given their ability to transform an investment asset into a liability or at best zero.

- **Excessive Leverage**

In the global highly leveraged financial system, many assets that are held as investments have been backed up by debt. A classic example is a rental property investment, where debt is used to enhance the return on the owner's equity. In an environment of declining asset prices, the high leverage combined with reduced rental income, can quickly turn the asset into a liability.

A recent, but far from isolated example is Sasol, which took on huge debt when expanding into the US. Now with project overruns and declining revenues (as the price of oil plummets), shareholders are the ones that become crushed as debt obligations remain in place while they are asked to inject more capital.

## When Investment Assets Turn Into Liabilities

- **Counterparty risk**

Most capital assets have what is known as a **counterparty** – i.e. the person on the other side of the trade. Where an investor acquires equity in a company, or buys a sovereign or company bond, he looks for ongoing performance from the counterparty. There is **always** a risk that the counterparty will not be able to deliver, and this needs to be factored into the rate of return required. The asset might not morph into a liability, but could go to zero.

### Conclusion

Risk levels are heightened where normally functioning markets are interrupted on the scale that we are seeing. The price point of money has been interfered with for many years and at this time more than ever before. The combination of these two main inputs into the free market economy can play havoc with a range of investments. Hence a greater focus on risk management.

As always, and especially in these trying times, our team is available to answer any questions that you may have. Please feel welcome to phone us on +27 21 914 4966 or send an email to [info@seedinvestments.co.za](mailto:info@seedinvestments.co.za) (general enquiries) or [wealthadmin@seedinvestments.co.za](mailto:wealthadmin@seedinvestments.co.za) (private client assistance).

Kind regards,



**Ian de Lange CA(SA)**

Director & CIO

(Image source : Hedgeye)

## When Investment Assets Turn Into Liabilities

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