Investment Commentary

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Lessons of investing are ignored

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The recent rally in financial markets is giving many investors a false sense of security. Their asset allocations are once again being unduly influenced by short-term momentum.

One might think that the rally would be an opportunity for big investors such as pension funds and endowments to sell into strength previously troubled and illiquid alternative assets or correlated high-beta investments, to restructure their portfolios more efficiently to fund liabilities. Unfortunately, the lessons of the past several years have not been learned.

The illiquidity and opaqueness problems of alternative assets such as hedge funds remain firmly embedded in portfolios despite the recent calamity. As the recovery in many markets masks those assets' imperfections, investment fads once again seem to be a greater driver of portfolio construction than the basic principles of asset allocation.

Investors continue to define asset allocation in terms of the number of asset classes in a portfolio rather than by the correlations between those assets. Alternative investments, which are not supposed to be correlated to equities, remain highly correlated (70-90 per cent by my calculations), but that has not deterred recent investment flows into alternatives. Meanwhile, investors are ignoring the fact that Treasury bonds are currently the only asset class with negative correlation to most other asset classes.

Chinese and Japanese investors have notoriously large positions in Treasuries, and may be the only investors today with truly diversified portfolios. If global growth accelerates and their domestic economies perform well, Treasuries are likely to underperform (especially given the associated weakness in the dollar). But those countries' improving domestic cash flows would probably make up for their investment shortfall in Treasuries. If their economies turn down, the odds are that Treasuries will perform well (and the dollar strengthen), counterbalancing weakening domestic cash flows.

It is remarkable that perhaps today's best examples of diversified portfolios, namely those held by the Chinese and Japanese, are criticised by the remainder of the investing world.

Investors should be trying to emulate their Chinese and Japanese overweight positions in Treasuries. Instead, Wall Street is striving to get the Chinese and Japanese to "diversify" like everyone else. In my opinion, the Chinese and Japanese should ignore the advice and stick with their Treasuries.

Despite the lessons of the past several years, investors are again allowing beta (market-related returns) to masquerade as alpha (returns based on manager skill). Hedge fund performance has rebounded coincidentally with a rebound in global equity markets. Investors should find these results somewhat disconcerting because they highlight how hedge funds are indeed no longer diversifying investments.

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Nonetheless, fund flows to hedge funds have recently increased. Correlation and diversification have apparently once again taken a back seat to short-term levered returns.

Investors should also not be fooled again by the myth that emerging markets have decoupled from developed ones. Outperformance is not a sufficient condition for decoupling. Based on monthly total returns over the past five years, the beta of the MSCI Bric Index to the S&P 500 is 1.6, and the correlation between these two indices is more than 75 per cent.

These statistics indicate that emerging markets offer little diversification, and are simply high-octane. Emerging markets outperformed when the S&P 500 was in a bull market, underperformed when the S&P 500 was in a bear market, and are now outperforming in another bull market. The evidence suggests that global markets continue to provide less, not more, diversification than they have historically.

Investors are once again allowing short-term, high-beta returns to drive their asset allocations. In the short term, as the global economy rebounds, these high-beta returns are very likely to be superior to those of more sedate asset classes such as large-cap growth stocks or Treasuries. However, as the past decade has shown, strategic asset allocation should not be based on shorter-term momentum but on the long-term stability and predictability of overall portfolio returns.

Alternative assets aren't alternatives any more. The returns of alternative asset classes have diminished and their correlations to other assets increased as alternatives have transformed from odd to conventional.

Treasuries are today's "alternative" asset class. Treasuries' returns continue to be negatively correlated to equities, yet they remain widely underowned because investors consider them overly risky.

Evidently, even the debacle of the past several years has not taught investors the age-old asset allocation lesson that diversification, and not short-term momentum, leads to higher long-term returns.

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