

Lessons Learned from the Recent Market Turmoil

By Brian D. Singer, CFA

Good investors learn from the results of every investment decision. As Will Rogers said, “Good judgment comes from experience, and a lot of that comes from bad judgment.” Market vicissitudes over the ten years from 1998 through 2008 have provided ample experience through countless opportunities for bad judgment. Many aspects of my team’s fundamental investment philosophy, such as our use of forward-looking risk models to incur only risks that we expect to be compensated, have been validated. However, other aspects of our process can be improved.

First, the industry has focused too much attention and energy on alpha-beta separation. Beta became regarded as a commodity incurred through low-cost passive investment vehicles and then forgotten. Alpha was increasingly believed to be the source of superior investment returns and so garnered extremely high asset management and performance fees. Many market participants learned the hard way that beta is not a commodity to be purchased and ignored and that alpha is scarce. Beta, while not compensated all the time, is generally easy to find and compensate over time. Alpha, on the other hand, is hard to find and, on average, is not compensated. After fees, it is negatively compensated. The vehicles designed to provide alpha separate from beta are called “absolute return” vehicles. This moniker reflects an underlying notion that only non-market risk is compensable. My belief in the superiority of “total return” vehicles supported by forward-looking risk analysis designed to identify and capture both market and non-market risks when they are compensated, and avoid them when they are uncompensated, was confirmed by the recent turmoil. Alpha and beta risk can be distinguished, but they should be evaluated on equal footing and incurred in proportion to their expected risk-adjusted compensation.

Second, asset prices can diverge from fundamental values for longer than the typical investment and performance assessment horizon. Based on extensive analysis of asset prices over long periods of time, as documented in *Investment Leadership and Portfolio Management*, I believe that the assumed time for the convergence of prices to values should be on the order of seven to ten years. Models of expected return should assume an investment horizon of at least seven years.¹ While the observed differences between prices and values do not change, the potential psychological and behavioral impact on clients and younger staff of dampening expected return ranges by extending the convergence horizon is important. Moreover, the great underexploited frontier of investing is capturing opportunities beyond the one-day to three-year investment horizons of most investors. In the alternative arena, frenetic trading over short horizons is more common than long-term investment strategies. Industry compensation has not accrued to those who wait; rather, human capital retention problems are the norm for long-horizon alternative investors. In the traditional arena, investment decisions are dominated by the three-year investment time frame imposed by consultants, mutual fund assessors and many other investment decision makers. Long-term investment opportunities arise and can be exploited as large groups of investment participants move in and out of strategies based on the same three-year performance track records.

¹ Ideally, the horizon over which performance fees are assessed should be identical to the assumed period that prices are expected to converge with fundamental values. Unfortunately, it is extremely difficult to implement such a long performance evaluation and fee determination period. Consequently, the performance period is likely to be shorter than the price convergence period.

Third, I have often used the ratio of price to value to communicate investment opportunities.² This ratio results in client misperceptions and is another potential source of bias for junior staff that can influence investment thinking and understanding. For example, if price is 150 and value is 100, then the price/value ratio is 1.5. The implicit impression is that there is a 50% discrepancy between price and value. Realistically, price is 33% above value, as price would only have to decline 33%, from 150 to 100, in order to revert to fair value. Conversely, if price is 50 instead of 150, the price/value ratio is 0.5. Again, there is not a 50% discrepancy between price and value; the discrepancy is 100%. Going forward, in order to avoid misunderstanding and potential behavioral biases, I will communicate discrepancies between prices and values based on the ratio of value to price. While this is a subtle and apparently trivial change, misunderstandings may be significant.

Fourth, the maximum loss on any investment, investment strategy or portfolio is 100%. Clients always want to know how much they can lose. The answer is always 100%. This question is the wrong question, and the answer provides no information. Rather, communication of loss potential should be communicated in the following manner:

There is a chance of a 50% loss in one out of every hundred years and a loss of 20% in one out of every ten years.

This is a more meaningful characterization of downside risk, conveys more information to clients, and helps to avoid misunderstandings.

Fifth, traditional finance teaches that diversification occurs with a large number of assets and with low correlations among assets. Correlations change and can be extremely high or low at inopportune times. Thus, increasing portfolio diversification by raising the number of less correlated securities is necessary but not sufficient. Unforeseen and unimaginable common influences or factors can affect all securities. As a result, diversification must include not only asset diversification; it must include process, behavior, operations and client diversification. Portfolios must be constructed with each and every source of diversification in mind. A primary means of achieving diversification in this expanded characterization is the use of third-party investment advisors. Building multi-asset portfolios involves extensive and *qualitative* application of forward-looking risk models to evaluate a portfolio's integrated risks - investment, behavioral, operational and client-related.

Sixth, investors are trained, we hope. They have a tendency to perceive downside and upside risk more symmetrically than untrained investors. They are less likely to panic or become greedy than clients or the great mass of investment participants. Accordingly, the behavioral responses of clients to downside and upside volatility are different from those of investment professionals. If clients experience fear and greed to the degree that they bail out of a portfolio, then they miss out on the overall investment performance that the investment manager ultimately achieves. Alternatively, and too commonly, clients can "train" investors in reverse by hiring investors with short horizons who experience fear and greed concurrently. For optimal relations, the client and investor must achieve a meeting of the minds. Investors must communicate openly and frequently with clients, so that there is no misunderstanding about extreme portfolio performance and so that clients understand the motivations and context for investing that will ultimately result in performance extremes. Information often fills a void that is otherwise filled with rumor, innuendo and misinformation. Close and transparent relationships between investment advisors and clients are critical tools in avoiding detrimental fear and greed responses.

² This "lesson" is mostly a communication issue. Investment decisions are based on risk and confidence-adjusted returns and not on raw discrepancies of prices and values.

Finally, and more subtly, convexity must be actively increased and decreased in portfolios, in response to market conditions. My research suggests that, like the eponymous Minsky Moment, periods of market stability result in a decline in the price of convexity (think of convexity as a form of insurance) and simultaneously sow the seeds of future instability by encouraging increased leverage and other forms of return-reaching behavior. As a rough rule, long periods of stability provide the opportunity to cheaply buy downside protection in advance of potential periods of instability. Conversely, periods of high volatility provide opportunities to sell convexity, or insurance, when it is richly priced. While these observations are by and large true (if much more complex than this simple explanation shows), the importance of actively managing the convexity of portfolio returns is a critical lesson from the recent market turmoil. Luckily, managing convexity is difficult and outside the realm of most investments. Accordingly, convexity allows for a distinct advantage in generating superior investment performance.