Investec
Wealth & Investment

Preparing for Increased Volatility

As equity markets continue to break all sorts of records, the most frequent question we are asked is “when will it end?” And invariably the answer has to be: “We don’t know”. There is no law that places a time limit on market cycles, nor on the economic cycles that tend to drive markets. Investors have been faced in recent times with innumerable banana skins on which they might have slipped, but they have been successfully dodged, allowing shares to continue their advance, backed by a recovering global economy and strong profits growth – a phenomenon known as “climbing the wall of worry”.

Of course, we are profoundly aware of the threats, and that has been reflected in the risk appetite expressed in the votes of our Global Investment Strategy Group. GISG has recommended a neutral risk position all this year, having been resolutely overweight risk for the previous few years. This position reflects valuations that are no better than fair value at a time when global monetary policy is being slowly tightened. There is also no end of geopolitical uncertainty to contend with – Trump, North Korea, the Middle East, and so on, none of which have managed to derail markets so far, but which remain “live”.

The position of more cautious investors is made more challenging by the fact that it is very difficult to generate a return on safer assets. Cash yields next to nothing; 10-year UK government bonds still only offer an annual return of 1.31%, which is a lot less than the current rate of inflation; high quality corporate bond yields also fail to keep up with inflation. This lack of “safe” return has been reflected in a recent reassessment of our Strategic Asset Allocation benchmarks, where we are placing greater emphasis on uncorrelated assets (i.e. those that tend not to perform exactly the same as equities or bonds, particularly in more stressful times). Examples of such assets include Infrastructure funds, a selection of hedge funds, and gold. We also remain well disposed towards Structured Products, although with the caveat that secondary market prices are vulnerable to short term losses.

It is worth reiterating at this point how risk is measured in these circumstances. In financial theory, risk is measured in terms of “volatility”. In layman’s terms that is how much the price of a financial asset moves up and down over a certain period of time, either in absolute terms or relative to another security or index. There are other elements of risk, such as permanent loss of capital or running out of retirement funds, for example, and we take these into account when advising clients, but volatility is the key indicator. And it’s very important that investors understand the relationship between volatility and investment returns.

Financial theory, notably Modern Portfolio Theory and the Capital Asset Pricing Model rely very heavily on the assertion that there is a linear relationship between risk and return – the more risk you take (i.e. the more volatile the asset), the greater return you will make **in the long term**. And there’s the rub. Investors have to be patient in accumulating those returns, and **be prepared to endure unrealised capital losses** on the journey. Our new SAAs incorporate a wealth of historical data (because, whether we like it or not, we can only look at history to establish the possible future outcomes). In the drawdown analysis, we have looked at the worst 3-year returns over the last thirty-five years for all the asset classes that we use as the building blocks for portfolios and then built those into five thousand simulations. The lowest risk mandate that we offer still has a theoretical double-digit maximum drawdown. The highest risk mandate could suffer a loss greater than 40%, although that must be put in the context of equity markets halving in 2008/09.

These are most definitely NOT predictions. They are a guide to what the worst outcomes could be. Unfortunately, by publishing them, our industry is in danger of creating a state of mind where people begin to focus on the worst outcome, an attitude exacerbated by the experiences of the Tech Bust and the Great Financial Crisis. However, the drawdowns experienced in both of these episodes were driven by factors peculiar to the moment. In the case of the Tech Bust, there was an egregious overvaluation of anything that claimed to be associated with the new-fangled internet, so the losses were very much associated with the TMT (Telecoms, Media and Technology) sectors. The downdraft was further fueled by the 9/11 terrorist attacks. Yes, Technology stocks have done well in this cycle, but valuations are much more amenable, business models are more sustainable, and there is no current evidence of the accounting frauds that came to light at the start of the millennium. The Great Financial Crisis, while rooted in the overvaluation of real estate assets, overstretched homebuyers and questionable banking practices, only really accelerated with the bankruptcy of Lehman Brothers and the seizing up of liquidity.

Today, banks are much better regulated and capitalised, while central banks are attuned, to the point of paranoia, to the risks of a liquidity shortfall.

In terms of the current economic and market cycles, we are aware that we are, almost by definition, closer to the denouement, but the factors are not yet in place to trigger a sharp sell-off. However, we have recently reduced our exposure to the high yield credit sector in favour of a blend of global sovereign bonds, as well as eliminating a currency hedge on our Japanese equity holdings. These trades have served to reduce the projected volatility and potential drawdown risk in balanced portfolios. In terms of regional allocations, we continue to shy away from the most overvalued market, the United States, and also the most politically challenged, the UK, while continuing to favour those with the best late-cycle potential – Europe (ex-UK), Japan and Emerging Markets. If we are to reduce risk further, cash will in all probability be the preferred asset class, as the next big down leg could well be driven by higher interest rates caused by rising inflation. This combination would be negative for both bond and equity markets.

Currently, the worst case scenarios (or maximum drawdowns) are not in our range of expectations for the foreseeable future. However, they should serve to remind all of us that temporary negative portfolio returns are a **fact of life** for any balanced portfolio investor who intends to be invested for a reasonable period. That may or may not happen over the next year or so, but we should all be mentally prepared for the possibility, because it cannot be avoided unless ones eschews risk completely, in which case the current monetary environment offers no potential for real returns.

John Wyn-Evans
Head of Investment Strategy
Investec Wealth & Investment Limited
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