Steinbrugge Comments On Market Sell-Off

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On Friday the Dow Jones Industrial average fell 665 points causing many investors to wonder if the 9 year bull market has come to an end. History has proven that most investors are terrible at predicting the direction of the market. To do so successfully requires two correct decisions: when to get out and when to get back in. Investors' emotions often drive their investment decisions. As a result, they typically buy near market peaks and exit near market bottoms.

Major corrections in the capital markets are a risk that investors must always consider. Experience shows the question is not if a major correction will happen, but when.

Events of the past couple of decades have led investors to expect markets to rebound quickly from a major correction. Seemingly forgotten is the worst sell-off of the US stock market, which began in 1929 and resulted in a decline of almost 90%. It took 23 years to recover. For those tempted to dismiss this as outdated data, take note that the Nikkei index hit an all-time high of approximately 39,000 in 1989. 28 years later it is still approximately 40% below its all-time peak.

Instead of trying to time the market, investors should construct a diversified portfolio that can withstand market turbulence thereby avoiding the need to sell at market bottoms. Unfortunately most investors significantly underestimate the "tail risk" of their portfolios.

When building out a diversified portfolio, investors seek to maximize risk-adjusted returns for a multi-asset class portfolio. Calculations to determine optimal asset allocations require assumptions for return, volatility and correlations (relative movement) for each asset class. These assumptions are based on a combination of long-term historical returns for an asset class, current valuation levels, and economic forecasts. Together, these variables can be applied to optimization models to help determine the asset allocation with the highest expected return for a given level of volatility.

Unfortunately, these models have proven to break down during severe market sell-offs. This was a painful lesson learned in 2008 when almost all asset classes declined simultaneously. The reason these models break down is because two of the inputs are dynamic. When markets sell off, correlations among both long only investment managers and various asset classes tend to rise significantly. When combined with a spike in volatility, this creates much more tail risk than originally perceived.

It is important to remember that hedge funds are not an asset class but a fund structure comprising of numerous investment strategies. Many hedge fund strategies have very low correlations relative to the capital markets benchmarks and some are, or have the potential to become, negatively correlated during a market sell-off. This was seen in 2008 when a few hedge fund strategies posted positive returns. Below is a list and brief description of some of the most diversifying strategies:

Reinsurance – This includes a range of strategies with very different return expectations and tail risks. The main common feature of these funds is their allocation to a portfolio of insurance policies where the primary drivers of return are insurance premiums earned and claims paid. Property risk (e.g. earthquake, fire, hurricane, and tornado) has proven to have very low correlation to the performance of the capital markets. This strategy has seen a significant increase in demand due to recent industry price increases.

Relative value fixed income - Strategies that provide liquidity to complex/less liquid fixed income securities have replaced bank proprietary trading desks. Skilled managers generate most of their return through alpha and actively hedge interest rate and credit spread risk.

Volatility – Volatility strategies trade options and futures contracts seeking to take advantage of overvalued and undervalued implied volatility levels in stocks, bonds, commodities, and currencies. Short volatility strategies, selling options and collecting premium, have been critically described as picking up dimes in front of a steamroller. Long volatility strategies, in contrast, can help diversify a portfolio; can have low correlation to the capital markets and often do well during market sell-offs as volatility spikes. The value of an option is based on a number of factors including the strike price, time left to expiration and implied volatility of the underlying security.

Commodity Trading Advisors (CTAs) - This category includes several different strategies, but is dominated by systematic trend following managers. These managers look to identify and capture price trends across multiple asset classes including currencies, commodities, equities and fixed income. A pure trend follower is indifferent to fundamental analysis or market valuations. As such, their correlation to the capital markets is, on average, very low. In fact, many have dynamic correlations that are positive in up markets and negative in down markets. There are also many non-trend following CTAs that provide positive skew performance distribution that can provide valuable tail risk protection.

Private Lending – Most of these funds are taking advantage of the difficult environment for small and mid-sized companies in securing financing from traditional lenders. There are wide differences in credit quality and yields of funds within the private lending space, but yields are typically much higher than traditional marketable fixed income securities. Many funds hold these relatively short term loans at book value and only adjust market value if there is an impairment to credit. As long as the liquidity provisions of the fund match the underlying investments and absent a significant impairment to the credit quality of the loan portfolio, these funds can provide very stable uncorrelated performance.

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