



Avoiding Investment Fads

Scale, surprise or time often reveal that the implicit assumptions behind investment fads are either unfounded or unsustainable.

Every few years, investment banks and asset managers “discover” a new way to improve clients’ investment results. Sometimes it’s a new idea, and sometimes it’s an old idea that’s been polished, repackaged, and pitched as new. While it’s impossible to predict with certainty whether these new ideas will work, historical examples demonstrate that investors need to look below the surface, and carefully examine the basis for the new idea’s promised performance.

We believe investors should focus on fundamental economic relationships. Too often these new investment ideas are promoted using assumptions that are specious and unlikely to hold. This Viewpoint will review several historical investment fads and illustrate how deeper analysis could have avoided or mitigated the attendant losses.



ALAN BILLER AND ASSOCIATES
INVESTMENT CONSULTANTS

(650) 328-7283
www.alanbiller.com



Portfolio Insurance – 1987

The concept behind portfolio insurance is that a put option can be replicated by trading between a risky and riskless asset. The idea was to create a portfolio that behaved like a combination of the S&P 500 Index and a protective put (i.e., a position that is simultaneously long both stocks and puts), and implement this strategy using low-cost S&P futures contracts. The marketing pitch was “sell your bonds, buy stocks, and *insure* them.” While the concept is consistent with the Black-Scholes option pricing model that earned its authors Nobel prizes, successful implementation required an efficient, infinitely liquid futures market.

By October 1987, portfolio insurance had become so widespread that when stocks fell sharply that month, futures did not behave as required. Specifically, prices in the futures market deviated significantly from underlying stock prices, violating the integral liquidity assumption that had always kept futures and cash market stock prices closely synchronized. On Black Monday (October 19, 1987), trading liquidity evaporated as portfolio insurance-related selling created and perpetuated a negative feedback loop. As a result, a previously unthinkable gap opened between futures and cash market stock prices. The purportedly insured portfolios lost significantly more value than the strategy’s proponents ever conceived or contemplated.

Tactical Asset Allocation (Market Timing)

The promise of tactical asset allocation (TAA) is clear: add value by overweighting asset classes or sectors that will outperform and underweighting those that will underperform. The difficulty is, as the famous economist Yogi Berra once said, “It’s tough to make predictions, especially about the future.” Moreover, one good prediction is never enough: successful market timing is achieved only by making several consecutive predictions that match both the timing and magnitude of markets’ inevitable ebb and flow.

As has been well documented in academic literature and industry press, asset managers and investment strategists have not been able to string together consistent records of accurate predictions. Too often a manager or strategist hailed as a guru after one successful call subsequently crashes by failing to make the next accurate prediction. Similarly, TAA models developed using statistical backtests miss the next tactical opportunity when changes in market structure or economic conditions depart from previous patterns and connections. Many managers and asset owners got the huge run-up in technology stocks correct in the late 1990s, only to ride over the financial cliff in the swift and dramatic price implosion that began in March 2000. Conversely, other pundits correctly predicted the tech bubble burst, but failed to get back into the market and missed the powerful bull run from 2002 to 2007.

Successful TAA requires getting temporary shifts right *and* correctly timing the return to the original strategic mix. A single, great call makes for a good CNBC soundbite, a compelling marketing campaign, or an enticing prospect pitch. But the evidence is overwhelmingly unsupportive of anyone’s ability to make consecutive correct calls across different economic environments and market cycles. As an avenue to alpha, TAA should be considered among the lowest in terms of strategy efficacy and investor confidence.



Commodity Indexing

In the late 1990s, articles were published promoting the accretive performance and diversification benefits of commodity futures. These articles argued that portfolios of commodity futures delivered a statistically significant risk premium that was independent of the equity risk premium (i.e., less than perfectly correlated). As a result of this purportedly rare and powerful combination, significant assets flowed into commodity futures index funds.

However, the research cited in these articles covered a period during which commodity futures traded primarily in backwardation (i.e., when the futures price of a commodity is lower than its current or “spot” price). As a result, futures tended to exhibit positive roll yield (i.e., futures prices appreciated when converging to spot prices at contract expiration). Shortly after the articles were published, commodities started trading in contango (i.e., when the futures price of a commodity is higher than its spot price), and roll yields turned negative (i.e., futures prices depreciated when converging to spot prices at contract expiration).

What proponents and investors missed was that the original research generated a surge in asset flows into commodity index funds which pushed futures prices from backwardation into contango and turned what had been a profitable trade into a money loser. Even if this backwardation-to-contango shift happened for reasons unrelated to index flows, investors should have exited the strategy as soon as roll yields turned negative.

Focused Equity Market Allocations

While today’s FAANMGs and meme stocks such as Gamestop will always draw excitement, the strategy of dedicating significant portfolio allocations to narrow market segments has both a long history and poor track record. Examples include the “Nifty-Fifty” stocks of the 1960s, Japanese stocks in the 1980s, technology/media/telecom (the “TMT”) stocks in the late 1990s, and the BRICs (stocks from Brazil, Russia, India, and China) in the early 2000s. In each case, investors were attracted by a run-up in prices accompanied by a compelling growth story. And in each case, asset flows triggered by enthusiastic investor demand pushed stock prices to rarefied (and in some cases, absurd) valuation levels. The subsequent, inevitable reconciliation with common sense and economic fundamentals eventually followed, during which stock prices collapsed by, in some cases, sickening amounts (e.g., between March 2000 and March 2002 the NASDAQ 100 was down 68%). As always, investors would have fared better by staying diversified and heeding warnings about unsustainable valuations.



Tail Hedges

What investor wouldn't want to eliminate their portfolio's downside risk at little cost? In addition to the portfolio insurance fad, multiple option-based strategies have promoted the promise of downside protection at low cost. However, when implemented, the cost of protective put options was often much higher than originally expected, making the strategy difficult to defend when it didn't pay off within the prescribed investment horizon.

While many tail-risk strategies are structurally sound, few investors have the patience and fortitude to stick with them. Moreover, these strategies are vulnerable to abandonment just before their payoffs are realized, namely when an extended bull market lulls investors into complacency, and the conspicuous cost of the protective puts starts to look excessive and unnecessary. Investors should evaluate these strategies and their cost across multiple volatility regimes—not just the current or most recent one. Importantly, investors must be confident in their ability to persevere with tail-risk strategies even when these strategies' fail to pay off during the originally contemplated investment horizon.

Hedge Funds

The enduring allure of hedge funds is promises of high, uncorrelated returns. However, all too often, the reality is that hedge fund returns are mediocre (especially net of fees) and exhibit a much higher correlation with equity markets than advertised.

When investing in hedge funds, investors must carefully consider and understand both the expected source of a strategy's return and that strategy's available capacity. If the hedge fund strategy is skill-based, what is the manager's edge? More importantly, is there credible reason to believe that edge can be maintained going forward or can other investors replicate the manager's decision-making and implementation, diluting or eliminating the strategy's original alpha proposition? Positive skill-based performance persistence is rare because the competition for alpha in capital markets is fierce.

Alternatively, if a hedge fund strategy's expected return source is a risk premium, is there a rational reason for that premium today and in the future? If the premium is structurally sound, will it persist when strategies seeking to exploit it garner ever greater asset flows? Similar to skill-based strategies, risk premiums and structural market inefficiencies often disappear when subjected to the increased demand pressures associated with elevated asset flows.



Summary

The common thread among these fads and trends is that they were based on assumptions that turned out to be either false or unsustainable in the face of increased investor demand.

- Portfolio insurance worked so long as only a small minority of investors used it.
- Tactical asset allocation assumed that the conditions leading to the first successful call would repeat.
- Commodity indexing assumed that futures would remain in backwardation.
- Performance-chasing, narrowly focused equity market strategies assumed that underlying growth fundamentals were limitless.
- Tail-risk strategies underestimated the realized variability in hedging costs.
- Hedge fund investors assumed that the skills and/or risk premiums powering past performance would persist.

In each of these examples, the better approach would have been to look carefully at the assumptions used to support or justify the promise of excess returns and consider whether those assumptions were sufficiently robust and sustainable if the strategy became popular and attracted big asset flows.

- How closely will future economic and market environments resemble the past? Evaluate both systematic returns (risk premiums) and the opportunity to generate alpha.
- Do the underlying assumptions fit economic and investment theory? Why should the risk premium or mispricing that generated the returns exist and persist?
- Look at the track record from a statistical perspective. How likely is it that the return stream could have been solely a function of luck? Did the value-add all occur in a short period or in one environment?
- Will money flowing into the strategy eliminate the opportunity?

Appendix: Term Structure of Futures Contracts

Backwardation and Contango are terms used in futures markets to describe the shape of the term structure (i.e., futures prices relative to time and contract expirations).

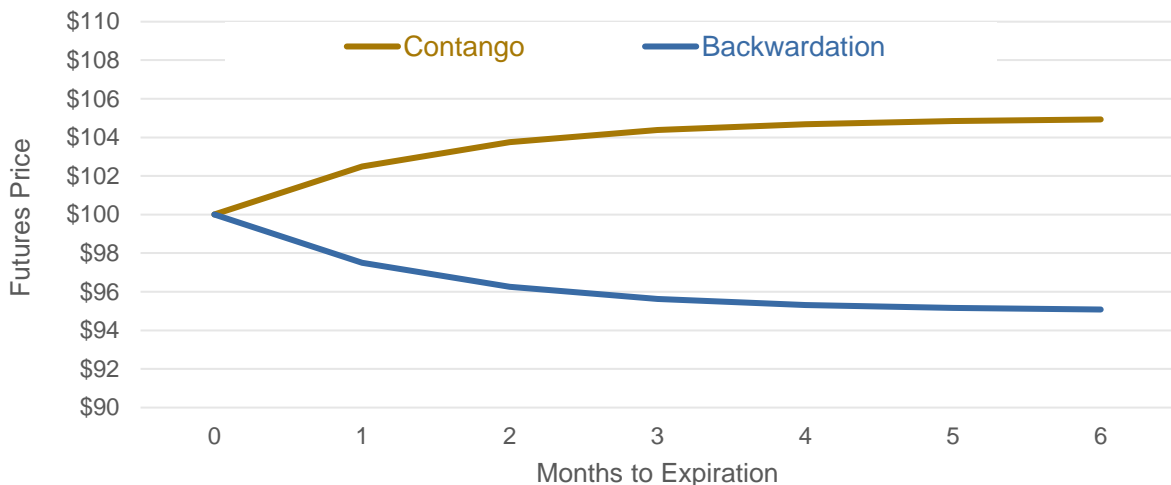
- **Backwardation** describes a downward sloping term structure in which the futures price of a commodity is lower than its spot (i.e., current) price.
- **Contango** describes an upward sloping term structure in which the futures price of a commodity is higher than its spot price.

Assuming that a commodity's spot price does not move, buying futures in backwardation will be profitable as the futures price will appreciate as it converges to the spot price by contract expiration. Conversely, in contango, the futures price will depreciate as the contract approaches expiration if the spot does not move.

Futures are used by both hedgers (e.g., farmers selling futures to lock-in prices in advance of their crop harvest, airlines locking-in next year's jet fuel costs, etc.) and speculators (e.g., hedge funds buying futures to profit from a proprietary price forecast). Supply/demand dynamics that incorporate the relative positioning and size of hedgers and speculators, as well as investors' willingness and ability to invest in the underlying asset directly (e.g., buy and store crude oil), will determine the price of futures relative to spot.

The traditional theory behind backwardation is that hedgers need to offer speculators a profit to get them to take the other side of the trade. Introducing price-agnostic commodity index funds may have upset the balance, pushing futures prices above spot (i.e., from backwardation into contango).

Futures Term Structure



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Visit us at www.alanbiller.com

Call us at (650) 328-7283

Email us at info@alanbiller.com



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