

# 2018. Lower Returns. Target Returns Or Target Risk?

Financial markets began 2018 with a surge. Equity markets closed on or exceeded historical highs, credit spreads tightened and sovereign bonds sold off. Commodities rallied with emerging market currencies as the USD sank. The first week of 2018 appeared to indicate continued risk appetite and exuberant sentiment, with some good reasons and some cautions.

1. We have a benign economic environment with a broadening and strengthening of growth. Despite the Fed raising rates and normalizing balance sheets, global liquidity conditions remain very accommodative. The change in fiscal stance in the US adds another boost to growth potential. As far as the economy is concerned, all is well.
2. Most investors agree that assets are expensive from equities to corporate bonds. The only justification for asset valuations comes from comparing them relative to interest rates. This makes interest rates an important factor in calling the markets.
3. Risk aversion is low. VIX index, an indicator of market participants' perception of future volatility, is near all-time lows. Options are a form of insurance policy and one buys insurance when one can, not when one needs.
4. As asset returns have outrun economic growth, investment opportunities have become scarcer. Combine this with the massive liquidity infusions of the past 8 years and witness the global rise in asset valuations. Old opportunities continue to creep up and new opportunities become inundated with capital.
5. One response to the rising valuations is to invest with

hedge funds. Hedge fund returns have been pedestrian in the past 8 years compared with their passive long only competitors but this has in part been due to central bank liquidity dampening volatility and increasing correlations. As central banks normalize, it is expected that dispersion and volatility will return to the markets providing hedge funds a more fertile hunting ground. However, investors have a tendency to allocate to the most recently best performing funds and, in the last year at least, these have tended to be the more beta driven funds.

6. The liquidity risk premium has also been compressed as investors give up liquidity for returns. Private equity and private debt valuations are near (and sometimes beyond) public market valuations reducing the liquidity premium.
7. As the Fed raises rates, even from such low levels, there comes a point at which it is not impractical to hold cash.
8. There are no immediate or apparent threats to economic growth or financial markets that investors can see. It is always difficult to identify catalysts to end a bull market. In 2000, the Dotcom bubble was only recognized by a few. In 2008, only a few investors recognized the bubble developing in the US real estate and mortgage market. Since the crisis, the market has shrugged off political risks (such as Brexit, Trump, the far right in Europe, North Korean missiles, and populism) as well as economic risks (QE taper, China's debt levels, Japan's national debt, Fed rate hikes and normalization). It is impossible to foresee what could derail this bull market but conditions are indicating a rise in exuberance and complacency.

How should one invest when growth is already robust and may

plateau, expected returns are lower as assets are expensive and the central banks are beginning to turn from extraordinary accommodation? There are several approaches. One is to maintain a fixed target return and increase the level of risk required to achieve it. The other is to maintain the level of risk and do one's best, accepting that returns may be lower.

What happens when investors target a level of returns? They get creative. In 2000, the Dotcom bubble had burst and taken the rest of Wall Street with it, the economy was suffering, and the Fed cut interest rates aggressively, from 6.50% to 1.00% in the course of two and half years. While this saved the economy, the stock market and the bond market, it meant that in 2003, investors seeking yield were finding it difficult to find any. Investors had to reach further for yield shifting weight from IG to HY, allocating more to junk, and then when returns have been squeezed out of traditional bond markets, turning to leveraged finance and ABS. CLOs, CDOs, SIVs, and other leveraged structures produced highly rated securities with arbitrage spreads which investors could take advantage of. The securitization of mortgages provided similar opportunities to benefit from diversification and leverage. When unlevered returns fall, returns targeting implies that leverage must rise. As leverage rises, demand for the underlying investment opportunities rises, at some point outstripping supply. When willingness to lend or invest outweighs willingness to borrow, or raise capital, the dynamics of the market change. Investors are no longer effectively policing markets and enforcing efficient price discovery. Subprime loans, liar loans, teaser rate loans, option ARMs, were inventions to encourage borrowing to feed the production of securities to satisfy investor demand. We know how that story played out.