

Why **asset allocation** still holds

Sparinvest takes a look at the recession and the rebound.

The lowest point of the 2008-9 market crash was reached in the March 2009. Since then, stock and bond markets worldwide have rebounded sharply and have now been in a strong upwards trend for a year. But the ride has not been easy. Markets have been very volatile and though the recovery looks strong on paper, it has felt very fragile to investors. One year on, confidence is still in short supply. It is at times like these that investors behave emotionally.



Danish Sparinvest believes that emotional investing is detrimental to long-term returns. We asked Senior Analyst and Strategic Asset Allocation expert, Sidsel Moeller, to explain why.

It is often said that 'bull markets climb a wall of fear'. Would you agree that this past year's recovery has constantly appeared under threat from all angles? How do you advise investors to cope in the face of such negativity and can you blame them for actively monitoring their portfolios more often than previously?

No, I don't blame them, and these recent 12 months have been very mixed in terms of the signals everybody has been receiving from reports in the media. But for individual investors who work in any area other than the financial sector, news tends to hit them later than the professionals. This means that they are always at risk of acting too late anyway. So my advice to individual investors would be to identify the portfolio where they feel comfortable with the possible losses at certain probabilities. Because if they can find a portfolio that is 'comfortable' for them, they can quit worrying about investment and concentrate on their family, life, work etc. increasing life quality in the here and now.

Would you agree that the temptation must be high right now for investors to take a year's strong profits and wait on the sidelines for the double dip that everyone seems to be expecting?

Yes, I do agree. And this double dip seems to be an extremely hot topic at the moment. I am certainly not dismissing the possibility that we may see a double dip in the near future. However, we should all be aware of the term 'Attention Bias' - which is something from which we probably all suffer. It means that the more something is talked about in the media, on the news, in conversations at work etc., the more we become convinced that it will actually happen. It becomes the 'perceived wisdom', the 'most likely outcome' and therefore can often become a self-fulfilling prophecy - even if it is totally based on emotion rather than on rational expectations. For the sake of argument, let's say this double dip will happen sometime, the question remains: 'when?' It's hard to find the right time to sell, because we certainly don't want to exit the market if there is still another 5 per cent return to be picked up before the dip. On the other hand, we also do not want to wait until the markets have already dropped 5 per cent - or 10 - or even more. And then, of course, we would need to get the timing right for reinvesting before the market picked up again so that we didn't miss out on further gains... and so it goes on.

Sparinvest advocates an investment strategy made up of three crucial elements: risk profiling, strategic asset allocation and regular rebalancing. Could you explain what each of these is and why it is so important? ?

Risk profiling is a way to find out exactly how much downside risk an investor can bear to be subjected to before he would decide to realize his assets with a significant loss. For institutional investors this risk profile is normally driven by regulatory requirements, liabilities, investment horizon etc. For the individual investor, it is of course determined by

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time horizon and liquidity needs, but also by psychology. For instance, how much can one lose 'on paper' before being induced to sell off the assets, thereby incurring a real loss? Identifying this theoretical 'sell trigger' is crucial so that the portfolio can be constructed in such a way as to minimize as the likelihood of the investor suffering losses greater than this threshold.

Strategic Asset Allocation is the process that enables portfolio construction to be in line with an individual's risk profile. It ensures both that the investor is aware of the size of the losses he may have to face, but also that it is highly unlikely that he will have to face a greater loss than he can bear. This makes it more likely that the investor will stay invested during downturns, meaning that he doesn't realise losses and remains in a position to benefit as the markets start to rebound.

Rebalancing is also important. Different assets move in different directions at different times. This means that the allocation of the portfolio shifts and, after a while, it may no longer satisfy the investor's risk profile. This should be monitored at regular intervals (not too often as there are transaction costs to be borne), and the portfolio adjusted accordingly. Another trigger for rebalancing might be a big market downturn. In this case, disciplined rebalancing would mean buying at low prices, and enjoying the subsequent upturn. Psychologically, it is very difficult to convince oneself to buy the risky assets that have just dropped significantly; however, regular rebalancing makes the portfolio less sensitive to great changes in the financial markets.

How do you find out someone's risk profile in the first place?

For the institutional investor this is determined by establishing the regulatory requirements and using, for instance, a risk budgeting model.

For the retail investor, we have a co-operation with Professor Dr. Thorsten Hens, one of Europe's greatest experts in behavioural finance. He has created for us a 'Risk Profiler' for individual investors. It works by establishing the inves-

tor's 'loss aversion' (which is the measure of how much a person can bear to lose before feeling compelled to actually sell and realize the loss.) Time horizon, liquidity needs etc. also come into play. The individual investor's portfolio is then optimized - not by using classic 'mean reversion optimization' because that only indicates the average risk and return profile of a portfolio. In real life, market returns do not follow normal distribution patterns and occasionally there are extreme events that take us beyond the normal scale of profit and loss. In order to find the portfolio that the investor can be comfortable with - even in the worst case scenarios - it is necessary to show him what his potential losses could be if an 'extreme risk' event occurs. Making the investor aware of extreme losses reduces the likelihood of him suffering a loss greater than his personal loss aversion threshold.

What is your evidence that an investment strategy built on risk profiling, strategic asset allocation and regular rebalancing works better than 'gut instinct'?

That depends on your gut instinct. If you are truly a psychic then, by all means, make the most of your licence to print money! Otherwise, be aware of the 'attention bias.' Ask yourself where this 'gut instinct' comes from. Is it simply because we have been bombarded by the media with stories about the impending 'double dip' that our gut instinct is saying that we should sell? Most people suffer from overconfidence. For instance several studies have shown that the majority of car drivers believe that they belong to the top 10 per cent of all drivers. This is, of course, statistically impossible. Likewise, we all tend to believe in our own ability to predict market movements. Unfortunately, unless you are a larger institutional investor, employing an army of analysts to examine what the next profitable moves should be,

rest assured that news of any opportunity will reach you much later than them, and they will already have taken their positions and the lion's share of any profit.

For example before the crisis, many investors actually borrowed money from the bank to invest in equities. 'What

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could possibly go wrong? The equity markets had been climbing upwards steadily for years and, just as we always tend to forget bad things, so we had forgotten that stock market investment involves the possibility of great losses. Anyway these investors had not only ignored the wisdom of the Asset Allocation approach, they had even geared their investment in risky assets. As markets fell, it became obvious that those investors who had their risk profile in place and who had constructed their diversified portfolio accordingly, did not suffer such great losses as the others because the diversification softened the blow. They also stayed invested (and have subsequently benefited greatly from this), because their risk profile had been determined beforehand.

You say that 'emotional' investors make the mistake of buying high and selling low, but markets have been growing strongly for a year now. So how would you advise someone who has been out of the markets since the falls of 2008-9?

Again, I believe that the only way to go about it is the three previously mentioned steps: risk profile, strategic asset allocation and regular rebalancing. It is really difficult, because such investors will also be suffering from regret bias. They have only recently (2008) realized great losses, and they do not want to feel the same regret again – and on top of that, they are regretting that they are not participating in the present upturn. But in any event, as retail investors do not have the same advantages in the markets as institutional investors - in terms of receiving early notification of investment opportunities - their next best option is to hold the portfolio that satisfies their individual risk profile. This approach will decrease the possibility of their realizing losses at – or close to – the bottom of any downturn, and allow them to enjoy the full impact of a rebound by remaining invested.

What about someone who has been invested but who hasn't rebalanced?

It will always be a good idea to check if the portfolio is still in line with the risk profile – and this should be done a bit more often in volatile markets. So if investors haven't rebalanced during the crisis, it might be a good idea to re-

establish the risk profile, (because the psychological biases of the investor may have changed as a result of the crisis) and then rebalance accordingly.

People have spoken about the 'lost decade' for global equities. Why shouldn't people just keep their money safe in cash and bonds and forget equities?

Well, other people are saying that the bubble is not in the equities but in bonds. And if it really has been a 'lost decade' for global equities, the counter-question could be why not invest now, as we are moving into a new decade for equities?

You have said that investing in the most undervalued stocks in the world is a strategy that pays off when recessions are over. Does the asset allocation strategy that you put together for your investors give increased exposure to undervalued stocks?

It depends on the investor's risk profile because if value stocks are more volatile and drop further than the general market during recessions, they may drop so far that they trigger the investor to sell and realize losses. But Sparinvest offers three Asset Allocation funds, all of which offer well-diversified portfolios, but with a tilt towards value.

Would you agree that high-yield corporate bonds are a very under-used asset class in Europe?

Again it depends on the risk profile of the investor, it is only underused if there are benefits to be picked up in terms of improved risk-return relationship – and seen in the context of the investor's risk profile. But even during the crisis when everything dropped (apart from low-risk Government Bonds and some other assets), there was a positive diversification effect from adding the high yield asset class to the portfolio, as correlations never reached 100%.

As a strategic asset allocator do you believe there is a place for Gold in a portfolio? Is it a 'safe haven' or do you believe, as Warren Buffett said, that it has 'no utility'?

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pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.”
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Warren Buffett has said many great things, and this is one of them. Investing in gold and digging a hole to put it in, hiring people to guard it does not create as much value as the act of contributing ‘risk-willing capital’ to companies that generate a real output.

But of course, in principle any well-diversified portfolio should hold all assets in the world, including gold.

Additionally, it is very difficult to invest in gold as such. There is a growing number of ETF’s with exposure to gold, but many of them create the exposure through derivatives, as it is difficult to do as Warren Buffett describes. This, in turn, means an exposure to counterparty risk, which

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was not what you intended, and certainly not these days. Maybe the best way to invest in gold is to buy it and wear it.

Gold in the long term has shown the same price development as inflation. But the major moves cluster around very short time frames, and mostly in times like these. The media will always focus on gold during crisis or in volatile markets. And as we suffer from the previously-mentioned attention bias, we start believing that it is the only asset to invest in these days. As gold is extremely volatile, very significant shifts from one day to another can be reported in the financial media. This happens most commonly when its price increases. I believe investors should be very careful, and consider that the trade-off between volatility and return may not be all that attractive when it comes to precious metals.

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