Beware of “investment catnip”
“If you don’t know where you are going, any path will take you there.”
The dilemma

• The search to “improve” portfolios – increase returns and/or reduce volatility – is ongoing

• Many innovations can be very appealing on the surface
  – Only the concepts or strategies with real substance will endure

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

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A major challenge …

Avoid the lure and distraction of ‘investment catnip’
What’s catnip?

A perennial herb and member of the mint family *Labiatae* that is well known for its ability to get cats high.
What’s investment catnip?

An investment product, strategy or concept that has significant allure due to its’ purported ability to increase returns, reduce risks (or both) but all too often only fixes yesterday’s problems
Be critical….

• Review tempting innovations with a clear eye to determine its robustness
  – Why should it work?
  – When won’t it work?

• Make the effort to assess how the new concept fits with your overall objectives and guardrails
  – Definition of success, e.g.,
    – offsetting pension liabilities or
    – providing an annual earnings stream to a charity, etc.
  – Willingness and ability to accept risk

• Many errors are repeated

• The appeal / lure can be strong
  – But like catnip, the substance may not exist
Examples of investment catnip

• Portfolio insurance
• 130 / 30
• Funds of hedge funds
• Absolute return portfolios
Portfolio insurance

Concept
- Synthetically replicate owning a put option on a portfolio
- Ability to pursue higher returns (increased exposure to stocks) without accepting more risk
- The ‘risky asset’ exposure would be unwound as the relative performance weakened
- Put a floor under asset levels

The allure
- Beat the assumed rate of return
- Perform in the top quartile of peer groups

The outcome
- Approach assumed and required continuous markets
- However, stocks ‘gapped down’ on October 19, 1987
- According to the January 9, 1988 *New York Times,*
  - The Presidential Task Force on Market Mechanisms, blamed the automatic trading programs … for generating huge sell orders that culminated in a 508-point drop in the Dow Jones Industrial Average on Oct. 19 as more than 600 million shares changed hands
- The ‘put’ was implemented far below the strike price, after stocks sank and bonds soared
- Ironically, prices reversed over the next week, after the losses had been realised
- Now repackaged as ‘dynamic asset allocation’
Hedge fund manager Paul Tudor Jones, who profited by buying stocks at the bottom, attributed the problem to portfolio insurance derivatives which, in his view, were “an accident waiting to happen”. According to strategists, attempts by people to put together arbitrage trades were undermined for several days by a steady flow of portfolio insurance stock sales.

Source: http://www.efinancialnews.com/story/2012-10-12/the-anniversary-of-black-monday-is-fast-approaching
‘130/30’

Concept
– Add value with 30% overweight in most attractive opportunities balanced by 30% short in least attractive issues
– Earn beta plus 160% alpha

Allure
– Potential for higher returns and a more efficient portfolio
– Gain an additional 30% of alpha on the upside bets and an additional 30% on the shorts – all without leveraging the portfolio
– 60% more value added without additional volatility
– Portfolio offered 'hedge fund light' in a period when the top pools of assets were endowments that numerous investors sought to imitate
– Widespread positive coverage support in the trade press and broadly endorsed by consulting firms

The outcome
Potential for investors in 130 / 30 portfolios to loose twice:
• The additional longs lagged the shorts
• The clients paid a higher fee than long-only for worse results
In 2007, when 130/30 funds first rose to prominence, consultancy Tabb Group predicted that the industry would reach $2 trillion by 2010.

F&C, JP Morgan, State Street, Threadneedle and UBS had all launched 130/30 funds by 2008.

Calpers, the Californian pension scheme, allocated $3.2bn to the strategy.

Scott Bondurant, global head of long/short strategies at UBS, said 130/30 had become a “hot” category and that, by the end of 2007, the marketing departments at most fund management companies “felt that they needed to have 130/30 products on the shelf”.

UBS had $2bn under management in the strategy at its peak, and now has just under $1bn.


Four years on from the halcyon days of 130/30, some investors have stuck with the strategy, but may not be pleased with the results. The $3.2bn Calpers invested in 130/30 strategies is now worth $1.6bn.

Funds of hedge funds

Concept
- Parallel the 'endowment model'
- Smaller institutions would have the benefit of a professional team able to evaluate, select, and monitor hedge funds
- Earn attractive returns with lower volatility than they would have seen using conventional long-only portfolios
- Diversified array of managers to reduce risk

The allure
- Successful diversification into 'alternative assets' including hedge funds
- In essence, they could 'be like Yale' without building an expensive staff

The outcome
- Investors mistakenly believed that 'hedge funds' represented an asset class
- Many packagers were better at selling than analysing and selecting managers
- Adding packagers’ fees to the managers’ fees left very little for clients
- The mix of managers was not nearly as diversified or as low correlation to equities as portrayed
- Only a limited universe of hedge fund managers earned their keep
Fund of Hedge Funds – In The Press

• Funds of hedge funds have faced immense pressure from the hedge fund community in recent years, with the future of multimanager vehicles being called into question as the make-up of hedge fund investors becomes increasingly institutional, sophisticated and experienced.

• 54% of investors intending to exit multi-manager vehicle investments are doing so because of the returns generated by these investments.

• 27% felt that investing through their own portfolio of direct investments can provide better opportunities in the hedge fund space.

• Fees are also an important consideration to those institutional investors looking to exit funds of hedge funds, particularly as they may feel that cash saved through avoiding the additional layer of fees could be used to build their own internal fund research and due diligence resources.

Absolute return portfolios

Concept
– A consistent absolute rate of return is more important than strong relative results
– Investors deserve reasonable results regardless of the investment climate

Allure
– The 2008-2009 financial crisis showed the downside of conventional beta exposure
– Portfolios and portfolio strategies designed to steer a less volatile course were preferable

Outcome
– Most providers of absolute return portfolios overpromised and under delivered
– Very few portfolios provided the promised safety against tail risks
– The insight to consistently hold the 'right portfolio' in all environments does not exist
Absolute return portfolios – In The Press

- Investors seeking shelter in absolute return funds during recent market volatility have had a disappointing year, with the majority of funds posting negative returns over the past 12 months.
- Funds in the absolute return sector lost on average 0.94 per cent over the past 12 months, according to figures from investor website FundExpert.co.uk. The two worst performing funds, L&G European Absolute fund and SVM UK Absolute Alpha fund, have fallen by 15 per cent over the year.

Source: [http://www.ft.com/cms/s/0/909b610e-dbeb-11e1-aba3-00144feab49a.html#axzz2AsBkKhCs](http://www.ft.com/cms/s/0/909b610e-dbeb-11e1-aba3-00144feab49a.html#axzz2AsBkKhCs)
Framing an investment assessment with a focus on the potential outcome is risky.
Today’s catnip?

'Alternative’ or ‘smart’ beta (non market cap weighted index)

Concept

– Indices designed to provide a return different from a cap weighted index
– Some are simple (equal weighted), some are complex (fundamental 'indices')
– Exposures not sources of alpha

Allure

– Market weighted Indices may have large exposures to individual issuers, Apple, Italian Government Bonds
– New weights have exposure to “Factors” which may have appeal from an investment perspective, or may limit exposure to issuers

Thoughts

– Each of these strategies introduces factor bets – for and against different portions of the markets
– Understand what you are betting on and betting against
– Recognise if you are making a bet for a period of time and need to correctly time when to remove the bet
  • Is the insight required to make and remove such bets part of your capabilities?
– Recognise that no set of factor bets produces a 'permanent alpha' – markets are too efficient with too many smart players looking for opportunities
Today’s catnip?

Catastrophe Bonds

• Insurance and reinsurance companies transfer extreme risks (for example: earthquakes and hurricanes), to financial market investors who receive a handsome yield in return for agreeing to cover damages they consider unlikely.

Concept
– High Yield in a low yield world
– Uncorrelated Returns / diversification benefits

Allure
– Synthetic triggers, a number of claims before any capital loss
– Disasters are uncorrelated with financial market and with each other

Thoughts
– On the surface the perfect product!
– Tail events are hard to price – so do they offer an attractive yield or not?
– Events are independent, but that does not stop them clustering
– Potential for many years of good returns, followed by a “catastrophic loss”
Investors need to be aware of the cyclical nature of the market and select the right time to invest, says Lane (Morton Lane, president of Lane Financial). “Right now we are in the middle of the wind season, so I would guess anybody putting fresh money in would wait until October until the majority of the wind season is over,” he says.

“If there is a large hurricane that causes a large loss, subsequent prices will be more attractive, that is lower, for new investors. If there is no serious hurricane this year, new investors will be investing at higher prices,” he adds.

Summary

- Clear definition of success is critical
- Temptations abound – 'the grass is always greener . . .'
- Focus on the drivers, not potential outcomes
  - Know what you are buying (or avoiding) and why
- Innovation drives us forward, Caveat emptor applies to all financial products