Positioning in Your Lane: Learning from Past Asset Cycles

October 2019

As I hope you will have seen, QMA recently published the conclusion of some substantial research we conducted over the last few months around the underperformance of value vs. growth. It’s not the purpose of this letter to reprise that (you can read the paper here) but I will comment that we have been delighted by the very high levels of interest we received from clients and media.

I was personally involved in the writing of this paper, as well as much of the communication around it. One of my themes has been how similar this period feels to the underperformance of value during the Tech Bubble, from the late 90s into the early 2000s. I was a Senior Consultant at Mercer at the time, which was a great seat to see how different managers coped with the bubble and its aftermath. Some performed well, generally by sticking to their guns, but many did not do as well — largely by doing the opposite. I hope I have brought the lessons of that period to my time at QMA, as we try and navigate this similar set of market conditions.

I remember two or three case studies particularly vividly, but the one I wanted to highlight was that of Phillips & Drew Fund Management (PDFM), which, after a series of corporate transactions, ultimately folded into what is now UBS Asset Management. PDFM was one of the four largest UK asset managers in the 90s, with a lot of multi-asset (balanced) business, but it was by far the deepest value manager of its peer group. Under its CIO, Tony Dye, now sadly passed away, PDFM also took a very bearish market view — to the extent that Tony acquired the media nickname Dr. Doom! One would naturally think that the Tech Bubble should have been a good, if testing, period for PDFM, since they were eventually on the right side of the key judgments, yet it didn’t play out that way at all. The interesting and much less discussed question is: why not? I think this has much broader lessons for investing through asset cycles.

I don’t know that there is an official history of PDFM, but if there is, I am certainly not the historian, so please accept what follows as a personal interpretation only, from my seat as a researcher. Typical commentary has focused on the value bias within equities as the culprit for their fall. From my perspective, there was a different reason — after all, other value managers such as Sanford Bernstein (as was) ultimately thrived. Instead, in my opinion, it stemmed from the way they made asset allocation decisions in their multi-asset portfolios. They established asset class ranges or position limits very early on, and from memory, they went to their maximum short position in equities (10% below benchmark) in the mid-90s, i.e., way before the cycle turned. Thus they had nowhere to go for three or four years, as the markets went higher against them. Even if clients stuck with them, they ultimately didn’t gain as much on the way down as they had lost on the way up. Had they started going underweight by a couple of percentage points each year, selling into the rising market, ultimately they would have been winners, not losers, on their positioning.
This story actually has very important implications for how we should all try and invest through asset cycles, which are an enduring feature of financial markets. If you are going to invest in cyclical assets, as a client or a manager, it is important to make the journey through the cycle worthwhile. Otherwise, why bother? Maybe the cycle will naturally lead to a higher place than its starting point, but that is not a given. In any event, it will always be advantageous to lean into a cycle, i.e., to deepen positioning as the cycle moves against you. In an ideal world, you would reach your maximum position at the trough of the cycle. The crucial corollary is that you never want to take your maximum position too early. Of course, it's never easy to time positioning so precisely, but this insight does favor processes that build in a deepening mechanism (such as we do with our adaptive allocation to value factors in equity portfolios, for example).

This sounds so obvious that you may say: doesn’t everybody do this? The short answer is: no. In real life, it’s much more challenging for a number of reasons. The first, which we’ll return to, is that it may not always be apparent what is cyclical vs. secular. However, even if you judge that aspect correctly, what this dictum means is that you would be increasing exposure to the underperforming asset or manager at the expense of the outperformer. This is naturally more difficult, both psychologically and behaviorally, since you would be running away from the herd, not with it. Yet I would argue that this is one of the easier ways of making money from a pure investment perspective. All you need to do is (a) judge that the asset is cyclical and (b) adopt some countercyclical decision mechanism. Even if you miss out on the optimal timing points, the cycle will do the work for you.

Before turning to practical examples, let’s return to the cyclical vs. secular question. I would say first that if there is one issue an individual or investment committee should spend time on before making allocation decisions, it’s this question, because the correct response will drive your choice so heavily. I would wager that more money has been lost on misreading this point in investment history than any other. Secondly, I would argue there’s a simple point to guide you: if in doubt, assume it’s cyclical! The burden of proof should lie firmly on those arguing for the secular position. Why do I say that so strongly? Because there are so many forces that inherently create asset cycles: underlying economic cycles, factor cycles, the general principle of reversion to the mean, e.g., through corporate competition. On top of that, you have human behavior, which is inherently pro-cyclical, as mentioned above. This can naturally create floods of capital chasing finite opportunities, with the unhappy ending that scenario invariably generates. Finally, in many cases this may be reinforced by the nature of return from the asset itself. Bonds, for example, typically have an upper bound for the maximum return that can be achieved. The reverse is not true: all of the capital can be lost, and this asymmetric payoff compounds the effect of cyclical decision-making.

So what might a disciplined countercyclical decision mechanism look like? This is obviously a big subject, but in essence I would suggest two key components, which reflect the different drivers of cycles. Of course, one element should be price, anchored in some way to the underlying valuation cycle. However, many of the worst cycles occur in non-price discoverable assets, and so some form of supply and demand-driven mechanism may be more suitable. Finally, borrowing from my PDFM story, I believe it’s worth incorporating some graduated positioning mechanism for formal or informal bands around allocations, rather than simply having an on or off switch.

Let’s look at these two key components a little more. On the price aspect, I will leave aside factors within equities, which feels a bit too self-serving, and exemplify through credit. I believe any end investor should always have a firm eye on the credit spread cycle when contemplating an increase or decrease in allocation. Credit has an asymmetric return profile and risks are compounded by the tendency for credit liquidity to disappear when challenges occur to either individual issues or the asset as a whole. Therefore, the basic principle is to be disciplined about rowing back from investing when spreads are relatively narrow, and to lean into investing when spreads are wider, irrespective of background economic distractions.
I have observed that applying this principle gets muddied in practice by what can be a simultaneous desire to change levels of bond exposure. The way to sidestep this trap is to explicitly separate the decision into its two components: i.e., government bonds plus credit spreads, and perhaps to consider an alternative payoff from a combination of lots of government bonds and a small amount of equities vs. a credit portfolio. The equity portfolio gives not dissimilar economic exposure, but typically with much greater upside if conditions are benign (since credit spreads have a lower bound). I have seen many market situations where the credit pricing is so tight in its cycle that it’s reasonable to imagine the combined return on the bond plus a sprinkling of equities will dominate a credit portfolio in both good and bad conditions.

This is not so easy with private assets, which are very topical at the moment. Indeed, if my conversations with headhunters are anything to go by, the fervor with which our industry is recruiting investors in private markets should immediately put you on your guard! How can we create a disciplined mechanism, when we don’t have prices to guide us as easily? My suggestion is to focus, instead, on trying to track supply and demand. In particular, I would focus on the demand for assets, i.e., the supply of funds. Generally, the supply of good ideas or good investments is relatively stable. It may ebb, for example, if bank lending is looser or tighter, but good new investments tend not to grow on trees. However, the potential supply of funds is much more elastic. History tells us that surplus capital allocation to private assets can dominate and drive the resultant return profile very easily over time. If you want to build a disciplined countercyclical decision mechanism, you should consider tracking the flows of funds (and dry powder particularly), then skewing your allocation in the opposite direction.

This final example may suggest to you, as occurred to me in discussing this letter with a colleague, the ultimate countercyclical indicator — an index of search firm activity by asset class. My experience suggests that it would be a perfect proxy for many of the ideas above. Whether in asset classes or markets, such is the bandwagon nature of our industry that by the time the average asset manager, let alone the laggard, decides it’s time to build a capability, it’s almost always approaching the peak of the cycle. So come on, Spencer Stuart, Korn Ferry, Russell Reynolds, etc., please put aside your commercial differences and find a way of combining your activity statistics. We’ll all be in your debt!

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QMA- 20191015-287