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Commentary: Navigating crises from a multiasset perspective


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The market havoc wrought by the COVID-19 crisis stands apart from all but a handful of events over the past century, including the Great Depression, the crash of 1987 and the global financial crisis. In such extreme environments, strategies that survived or even thrived in other climates may suffer ruinous losses.

While it's still too early to predict the pandemic's ultimate economic and financial impact, it's not too soon to consider lessons learned from an investing perspective. The following three broadly relevant principles, which we'll view through a systematic global macro lens, can help investors successfully navigate crises.

Durable diversification

The first is commitment to what we call "durable diversification." The post-GFC environment rewarded equities and, in particular, U.S. large-cap growth stocks. It punished asset owners that, in a low rate environment, had allocated to alternatives to meet performance targets without taking on unacceptable equity exposure. In the months prior to the COVID-19 crisis, dissatisfaction with diversification was on the rise.

Further compounding the problem, the question of how to achieve durable diversification, in other words, diversification that holds up under market stress, is enormously challenging. In fact, many strategies that were sought to expand or better balance sources of return, including alternative risk premium and risk parity, have experienced significant performance volatility. The likely cause is exposure to a handful of conventional return drivers and concentrated directional positions. Moreover, a variety of hedge fund styles exhibit significant downside betas, in conflict with expectations of market independence, and effectively deliver a premium for underwriting crash-risk rather than high risk-adjusted returns. Meanwhile, in private markets, non-mark-to-market performance measures mask true economic risk and correlation to equity markets.

Durable diversification requires an expansive investment universe. Benefits include the flexibility to avoid concentrated exposures to individual assets, markets and countries, as well as to increase the number of distinct views expressed in the portfolio. In practice, many strategies intended to diversify don't fully exploit available heterogeneity in and among asset classes. Commodities offer an ironic example in that they are often excluded from multiasset offerings precisely because they're regarded as "too different," requiring specialized industry expertise to assess return drivers for individual sectors. But because they are so different, commodities greatly expand the opportunity set when added alongside equities, bonds and currencies.

Durable diversification also calls for drawing on a wide range of traditional and alternative data sources to model the specific behavior of each asset class. Moreover, the crisis has highlighted the importance of balancing fundamental, momentum and carry themes with macro factors such as growth, inflation and stimulus, which have delivered in an environment where asset prices are particularly sensitive to economic and policy drivers.

Dynamism

A second principle is dynamism in the investment process. In the COVID-19 crisis, investors have responded to waves of information about the virus' spread, its economic and financial impacts, and the efficacy of health-care and economic policy responses. Financial markets are powerful information aggregators, and different markets process news

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with varied emphases and speeds. Macro signals derived from market measures, including bond yields, credit spreads and commodity prices, have transmitted more timely and comprehensive information about economic and financial conditions than traditional indicators, such as government statistics and surveys.

As examples, commodity markets, both petroleum and industrial metals, offered early warning signals of COVID-19's threat even as equities reached all-time highs. They also informed inflation forecasts, which flowed through into the outlook for sovereign debt and currencies. Similarly, gold offers an illustration of the dynamic nature of cross-asset relationships. While gold is often seen as a safe haven, during the COVID-19 crisis, it surprised investors by plunging and then rebounding with stocks. We can make sense of this procyclical episode, however, by taking into account specifics of the macroeconomic environment, especially the behavior of real interest rates and the U.S. dollar.

Dynamism is just as crucial in forecasting risk. Strategies that fail to adapt position sizing and leverage in response to spiking market volatility tend to suffer.

Sophistication

A third principle of crisis navigation is the embrace of sophistication throughout the investment process. In forecasting returns, we believe that markets are inefficient but difficult to beat. Designing signals that generate high risk-adjusted returns requires deep domain knowledge, thoughtful construction, and ongoing research and development. Instead of delivering high risk-adjusted returns, generic formulations are more likely to be polluted by unintended risk exposures or to represent returns premiums that have been arbitraged away.

Commodities again provide a powerful illustration. Treated as a monolithic asset class, they offer a degree of opportunity and diversification with substantial downside risk. It is only by embracing commodities' heterogeneity and complexity that investors can unlock their full potential.

In risk management, sophistication implies tail-focused, forward-looking and market-aware approaches. In contrast, crudely designed short volatility strategies were vulnerable to potentially devastating losses during the violent March sell-off. More nuanced implementations make use of vehicles that avoid explosive payoffs, adaptive controls on position sizing and scenario analysis to control potentially explosive exposures. Moreover, the crisis has highlighted the value of specialized options expertise to craft volatility-based positions that provide defensive benefits at reasonable cost.

In portfolio construction, many multiasset strategies, including alternative risk premium, employ simple approaches, such as fusing together style portfolios formed within siloed asset classes. But the conceptual starting point should be a methodical trade-off at the individual asset level of expected return against both risk and costs. The comparative simplicity of heuristic alternatives has costs. It inhibits the recognition of cross-asset relationships, such as equity betas of currencies and commodities, and control of total country risk exposures. Moreover, lack of a means to methodically trade off implementation costs against forecast returns restricts investments to the most liquid markets and instruments at the expense of assets that are inefficiently priced because they are difficult to trade.

Conclusion

Conventional wisdom holds that systematic processes generally require significant intervention during crises, but this isn't the case. The COVID-19 crisis has highlighted more appropriate takeaways, including the value of expanding the breadth of assets and underlying returns drivers to achieve durable diversification. It has also reinforced the importance of dynamism in every phase of the investment process. Importantly, changes in market-based measures and their interaction provide investors with timely information about rapidly changing conditions. Lastly, none of this can be achieved without an appropriate degree of sophistication, which is required to capture the heterogeneity within asset classes and interactions between them, and to protect portfolios against a wide range of risks in different market environments.

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