The Rennie Quarterly Return

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Risk on – Risk off

Current global financial problems, kicked off by the collapse of US subprime mortgage prices in 2007, has been a period during which risk asset prices moved almost in lockstep, a characteristic which is at least partly attributable to the advent of the 'risk on – risk off' trade.

Crisis & Correlation

In 'normal' economic times, often defined as the economy comfortably plodding along the sine wave cycle of expansion – peak – recession - recovery, domestic and foreign stocks, bonds, commodities, real estate and currencies tend to move more independently, or with low correlation to one another.

Risk On	Risk Off
Stocks, corporate bonds, some gov't bonds, commodities, real estate, some currencies, gold	US Treasuries, US dollar, Japanese yen, Japanese gov't bonds, Swiss franc

Since 2007, that sine wave has been interrupted by several metaphorical tsunamis, one very real. Most important were the subprime mortgage collapse, the Lehman Brothers failure, the Japanese earthquake, the US liquidity freeze, and finally today's European mountain of sovereign debt.

Successive negative headlines drove skittish investors to abandon the time-tested endeavor of choosing risk-assets based on thorough research. Instead, they simply sold all risk-assets. As investors fled, prices fell in lockstep; correlations across risk-asset classes rose dramatically.

Risk Off

Ignoring concerns regarding US fiscal discipline culminating in a ratings downgrade, US Treasuries maintained their position as the preferred risk-off asset. Nervous global investors poured money from risk-assets into US Treasuries, and by default the US dollar. They also found refuge in the Japanese government bonds, yen, and in the Swiss franc.

Unfortunately, risk-off portfolios themselves introduce purchasing power risk, which erodes as the portfolio returns fail to keep pace with inflation in today's interest rate environment. Furthermore, the next positive headline leaves the risk-off portfolio owner lamenting missed opportunity.

Risk On

Just as the risk-off trade abandons traditional investment selection when selling assets, it seems the slightest hint of positive news causes those left holding risk-off portfolios to reinvest across all risk-asset classes simultaneously. As a result, the broad-based buying drives correlations across traditionally unrelated asset classes ever higher.

Implications & Effects

What are the implications of such broad-based buying and selling? High correlations across risk-asset classes challenge portfolio risk reduction through asset allocation.

Furthermore, consider that most active mutual fund managers continue to follow traditional tenets of research-driven security selection. When waves of trading volume hit the market paying no regard to individual security value, relative security value lies submerged until the tide wanes. However, savvy active managers will take advantage of those nuggets of gold cast away with the tailings, improving returns over the long-term. In the meantime, distinguished performance is muted.

Finally, while not immediately apparent, the risk on – risk off trade is another market timing strategy, which research has shown to be an expensive and futile endeavor over time.

Instruments

It is likely that the advent of ETFs has helped facilitate the risk on – risk off trade. Investors now have the ability to instantaneously sell or buy a broad segment of the financial market in a single transaction. Risk-off has evolved from selling a few underperforming stocks or assets to selling every stock in the S&P 500 via an ETF.

When will it end?

The dominance of the risk on – risk off trade on returns will likely persist until the global economic recovery is more secure. However, the trend toward higher security correlations in times of crisis is probably here to stay.

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Our Two 

To me, consensus seems to be the process of abandoning all beliefs, principles, values and policies in search of something in which no one believes, but to which no one objects.

Margaret Thatcher

Quarterly Trivia:

Of all the goods & services produced since 1 AD, what percent was produced in the last decade?

Over 23% (The Economist)