Balanced funds are more volatile than markets!

Capital markets seem to have calmed down somewhat this year. The volatility of equities is at a five-year low and that of bonds - despite the recent rise in interest rates - is below the 2011 and 2012 levels. However, after having withstood two major crises, balanced portfolios have recently seen their volatility increase significantly. Understanding this paradox is paramount, because the reasons for the past success of these balanced allocations are clearly turning out to be a risk today. Their reversal could have a significant impact on markets, and in a way that could be all the more insidious as it is not visible at first glance.

Volatility is only one of the factors that contribute to the risk of a balanced portfolio, which is also strongly determined by the links, i.e. correlations, between assets. When the latter move independently, or in opposite directions, portfolio performance is largely mitigated. This is due to the concept of diversification, which broadly means that the risk of a diversified allocation is lower than the sum of the risk of its components. In addition, modern financial instruments, in particular derivatives, allow correlations to be made the most of dynamically. These hedging strategies include the ability to quickly ‘protect’ investments when danger arises.

These two risk reduction engines, which have been widely used in balanced funds, have lost some of their potency in recent years, before finally seizing up in the past few weeks and causing increased volatility in many portfolios, despite the fact that markets have been relatively quiet.

Diversification and hedging, the results of financial deregulation

The reliance on diversification was originally helped by the financial deregulation of the 90s. Investors in developed countries were able to invest abroad gradually and to take advantage of new opportunities, without incurring greater risk due to the low correlation of these investments with their traditional holdings. To be sure, the difference in behaviour between emerging and developed markets, or between stocks, bonds and currencies, was then quite pronounced.

Simultaneously, banks took advantage of deregulation to develop a wide range of derivatives that were gradually incorporated into portfolios to remove unwanted risk or quickly protect them against unforeseen events. These simultaneous developments initially had genuine advantages, since they improved the safety of markets for consumers by reducing risk while preserving potential performance. Attracted by these developments, investors flocked into global balanced funds, or they themselves directly applied the recipes of balanced asset allocation. Until the mid-2000s, deregulation benefited all.

Since then, the value of diversification has waned gradually. Admittedly, investors have seen their investable universe expand considerably, but, by all using the same techniques, they have ended up with very similar investments. They have thus transformed the market into a monolith, so that when a shock occurs, such as the sub-prime crisis, they all end up adjusting their portfolios in the same way at the same time. As assets then move in unison, diversification is conspicuously absent at a time when it is needed most. In concrete terms, a surge in volatility, well beyond that of the underlying assets, compounds the drop in performance. Since then, diversification has thus remained largely illusory, unnecessarily reducing risk during calm periods and increasing it at each and every shock, like an umbrella that gets stuck as the first drops of rain start to fall.

While confirming the demise of diversification, the two crises of 2008 and 2011 have led to a massive increase in risk aversion. Investors have significantly shortened their investment horizon, reflecting their strong intolerance for underperformance. The market has consequently remained monolithic, but this time by relying more on hedging strategies, which are particularly effective in the absence of diversification. The depletion of the first engine has doubled the power of the second. Once again, the overuse of the same strategy by all players has ended up diminishing the effectiveness of the strategy itself. The major hedging assets have gradually been emptied of their substance. They have fallen one after the
other, by their own weight, sometimes with the help of governments or central banks, each one aware of the risk of being the only one offering safe havens to all of the world’s refugees.

The Swiss franc, which was used massively in 2011 to offset the Euro debt crisis, lost its status within a few hours after the intervention of the Swiss National Bank.

The euro, which investors had sold short for the same reasons, caught many of them wrong-footed as it strengthened after Mario Draghi’s statements last summer, to such an extent that it won the prize of the strongest currency in the past twelve months!

At the end of 2012, the yen, historically a safe haven (if ever there was one), was the victim of the Japanese government’s new monetary activism.

Lastly, and more recently, investors witnessed a collapse in gold prices and in the bonds of the major developed countries, with an increase of nearly 1% in U.S. ten-year yields in less than a month, the strongest move since 1994, and a 30% drop in gold prices, not seen since the 80s.

The list of possible safe havens has thus shrunk inexorably and led to the subsidence of diversification options. It is the disappearance of the last options available that caused the recent surge in the volatility of global balanced portfolios. There are no more trees to hide behind!

The two traditional ways of reducing risk in a balanced allocation have thus truly been depleted, as the victims of overconsumption. Diversification and hedging have proven to be non-durable resources. It will probably take several years for them to regenerate. What is worse is that this can only occur through the dislocation of markets and through severe damage to investors. June 2013 was merely a prelude to this development. Despite this brutal setback, the exposure to G3 bonds and to gold that has been accumulated over the years to reduce risk remains very significant. Along the same line, the massive capital invested in emerging markets by investors seeking diversification, a quest that has now become illusory, is far from having been repatriated.

The increased volatility of diversified funds should force many investors to reconsider their options, especially since they had invested in these products specifically to enjoy lower volatility. The end of quantitative easing in the United States and the slowdown in emerging countries should provide an economic justification for the reallocation of balanced funds. In view of the amount of capital involved after five years of massive investments facilitated by the funding provided by hyperactive central banks, the return to normal could prove extremely abrupt.

The correction in June should be seen as a warning signal. The season of strategic choices that opens in the Fall should be marked by major reallocations associated with a very substantial wave of capital repatriation: from emerging to developed countries on the one hand, and from high-yield bonds to equities on the other hand. This will inevitably lead to an increase in volatility that will be impossible to conceal.

For market participants, this is obviously not good news, because it will be more difficult to absorb market volatility. But while it is no fun to be declared ill, it is still the first step towards healing. Investors have become addicted to a drug whose effects have been decreasing. The time for rehabilitation has come. Market sobriety commands that extra yield is often accompanied by higher volatility in the short run; that a real prospect of capital gain sometimes requires patience; that hedging strategies have become unreliable, and that, at best, they bring lower volatility for only a week or a month, often at the cost of a significantly reduced gain outlook; that lower volatility in the past is not always synonymous with a good control of future risk. In short, we must address the looming period of unrest ahead by returning to the old principle of the real value of an investment, taking into account its risk and time horizon. We must invest in a straightforward way using neither tricks nor artifice. To put it simply, we must assume all the consequences of our investments.

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