Where are Risks Hiding? Can They be Avoided?

Hint: Fixed Income → Market Neutral.

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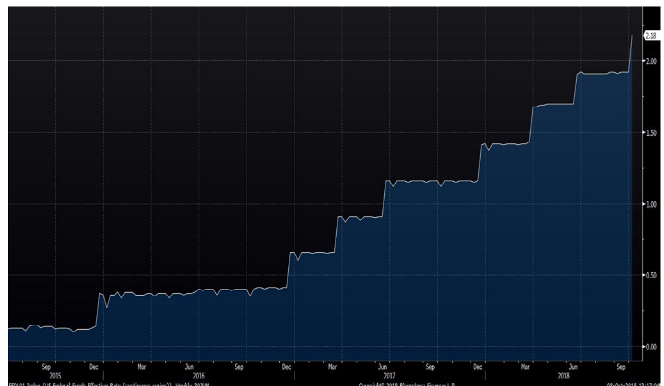
Of the two major asset classes, stocks & bonds, which presents the most risk? We propose that bonds present more risk than equities in the current environment. Moreover, we offer the market neutral suite of products as a solution to side step the risks mounting in the fixed income landscape. We present the potential benefits of an uncorrelated strategy for an environment with heightened valuations, rising rates and a very mature bull market.

Let's first talk about two notable trends in the U.S. economy and determine if they adversely affect each asset class. Since late 2015, the U.S. Federal Reserve has been raising interest rates (Exhibit 1). As interest rates continue to climb, duration rears it's head and negatively impacts investments. Fixed income investments have notably more duration than equity investments. Therefore, a rising rate environment most adversely impacts fixed income markets.

Another economic trend that had been in place since 2015 is the increasing inflation rate. The U.S. Urban Consumer Price Index (CPI-U) has moved up steadily since early 2015 and nearly hit 3.0% in mid-2018 (Exhibit 2). Inflation is generally not good for stocks or bonds. Additionally, inflation is dramatically worse when the rise in inflation is rapid, unexpected and significant. Since this recent uptrend is none of these, we will discuss the impact of a continuation of the current trend.

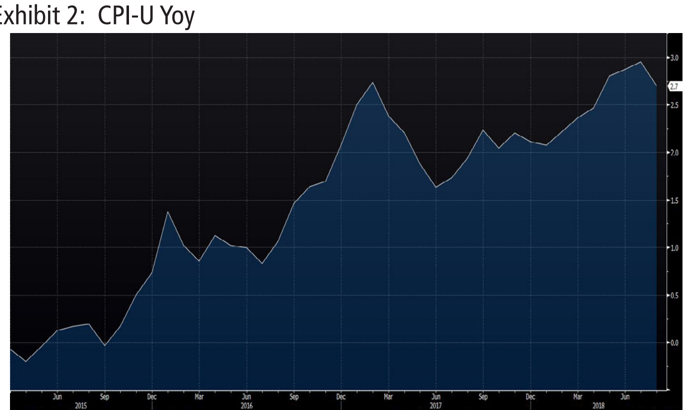
It is generally accepted that stocks provide a hedge against inflation as they are better able to pass costs to customers. Most fixed income market participants will tell you, inflation is a bond's worst enemy. Inflation erodes the purchasing power of bonds' fixed coupon payments and pushes up interest rates as investors demand higher yield to compensate them for inflation risk. It seems quite obvious then that inflation has a much more adverse impact on bonds than stocks. In conclusion, rising rates and inflation produce serious risks to the bond market, and as investors continue to pile into bonds (Exhibit 3),

Exhibit 1: Fed Fund Effective Rate



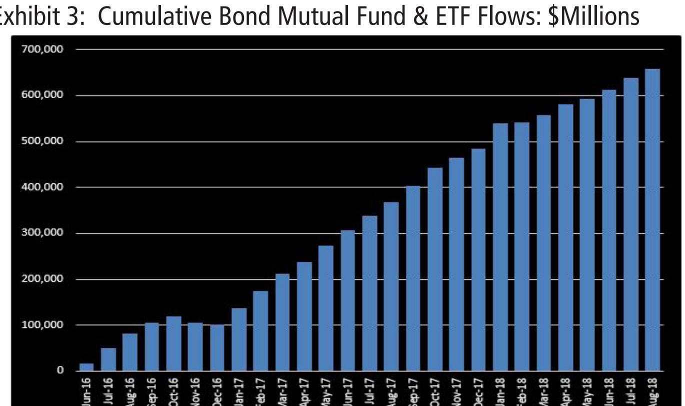
Source: Bloomberg

Exhibit 2: CPI-U Yoy



Source: Bloomberg

Exhibit 3: Cumulative Bond Mutual Fund & ETF Flows: $Millions



Source: Investment Company Institue

it seems they are turning a blind eye to these risks and a potential down turn based on the economic environment. Richard Bernstein of Richard Bernstein Advisors said, "Enthusiasm for an asset class in the face of deteriorating fundamentals seems a classic setup for a significant bear market in bonds." [1]

Traditionally investors have built portfolios of stocks and bonds to take advantage of the "free lunch" diversification that modern portfolio theory provides: return with less risk. However, given today's environment, as Nick Colas and Jessica Rabe of DataTrek Research have astutely pointed out, "U.S. equity/bond correlations are now resoundingly positive, as today's market action clearly shows. That's new. We're coming off a 20-year cycle where correlations were profoundly negative, with bonds providing the perfect hedge against equity market volatility." To us this means investors must look beyond bonds to construct their portfolios. Nick and Jessica have a similar view, "All this means two things. First, investors should underweight bonds and/or shorten duration. Second, expect more jumpy days ahead." It's our belief that the antiquated "60/40" portfolio that has served investors well during the 30-year bond bull market, is in serious need of a "tune up."

So, if bonds present deteriorating fundamentals, no longer providing that lowly-correlated return stream, and we are entering into the tenth year of a bull market with heightened valuations, where might one look for stable returns? We recommend looking to alternative investments, more particularly, **market neutral strategies**. Market neutral strategies are sizably hedged by taking long and short positions in stocks and seek to deliver returns that are independent of broad stock market movements. As the alternative marketplace continues to mature, there are a number of high-quality managers with significant track records of delivering consistent stable returns that can help reduce portfolio volatility and help maximize the risk/reward trade off. And as interest rates rise, market neutral strategies notably benefit. The cash generated from short positions can offer returns that provide a strong and stable tailwind for investors. Rising interest rates also tend to penalize companies typically held as short positions with weak or strained balance sheets another potential benefit for owners of market neutral strategies.

Given the market environment that we see today, a meaningful allocation to a market neutral strategy can notably improve the risk/reward tradeoff for investors relative to the traditional stock/bond portfolios of the past. Offering more stable returns, lower correlation, improved risk/reward tradeoff, tailwind from rising rates, and meaningfully hedged allocations – we believe that a market neutral strategy can deliver where bonds are falling short.

David & Justin are portfolio managers at Convergence Investment Partners where they manage multiple long/short strategies, including a Market Neutral Strategy. Convergence has been managing long short portfolios for nearly fourteen years and rely on a systematic process born out of fundamental analysis and rigorous empirical validation. For more information on this article or Convergence please visit their webpage www.InvestCIP.com or email info@InvestCIP.com.