

"Risk-on" Is a Misunderstood Risk that Needs To Be Hedged

- In a "risk-on" environment, investors tend to put more money into riskier assets like stocks, and whenever I say "risk-on" is itself a risk that needs to be hedged, I get funny looks.
- But it is important to emphasize this is a market with two fat tails. The right-tail is "risk-off," which many understand needs to be hedged, and the left-tail is "risk-on," one less understood, but one that also needs to be hedged.
- As a result, the investment profile for 2023 is one of a short and fat distribution of risk. By definition mathematically, volatility will be higher than historical averages.
- Context is important, where today a historically high \$5 trillion in cash sitting on the sidelines (ICI as of 12/31/2022) hoping it's the right place to be, but fearful it's not.
- It is important to remember that there are two types of investor losses 1) a repeat of 2022's negative performance, and 2) missing out on a potential 2023 rally to recoup some of those losses.
- So how to we invest in this type of market? Get balanced. One needs to construct a portfolio that balances both tail risks and manages towards the middle.

Jim Caron: Whenever I say "risk-on" is a risk and, as such, needs to be treated like any other risk that needs to be hedged, I get funny looks. But this is an important point to emphasize and what I see is a set-up in the market with two fat tails. The right-tail risk is something that most people understand, that when bad things happen, that's the risk that needs to be hedged. But there's also a left-tail risk, the risk-on scenario which also needs to be hedged. But as a result of all of this, I think the investment profile for 2023 is one of a short and fat distribution of risks. We've talked about this in several podcasts that this year has two fat-tail risks and a short, fat distribution, something we need to respect mathematically. And by definition this means that volatility will be higher than ordinarily around this type of a distribution of risk. If we take this on board and we build an investment portfolio around it, I think that starts to be the key. Now, context is extremely important in this environment. Today's context is historically high levels of cash, nearly \$5 trillion in money market funds (ICI as of 12/31/2022) is sitting on the sidelines hoping that it's the right place to be, but afraid that it might not be. Let's get into this.

The first thing I want to address is the attendant risk of holding high levels of cash. If you hold a lot of cash, most people think there's really no risk or there's very little risk, but in this particular case because we have these fat-tail scenarios of either not-so-good things happening or good things happening, that having high levels of cash does start to pose a risk to investors. The first question I ask is when something is near extreme levels like they are today in these cash holdings, I always ask why there are holdings of cash and money market instruments at such extreme levels? The simple answer is because investors are scared especially after what returns were like in 2022. It makes a lot of sense that people are scared, scared that 2023 might produce negative returns. You know which is the right-tail event, but there's also another risk too and it is being scared that one misses a rally in the markets, and that's the

left-tail event. Let me say that again - it's being scared where one misses a rally in the markets is a left-tail event, fearful that one misses out on potential positive returns to make up for last year's losses.

Whenever people are scared, they do funny things. Don't underestimate the powerful human emotion of "loss avoidance," where the pain of loss is greater than the pleasure associated with gain. Loss avoidance helps explain why investment in money market funds is nearly \$5 trillion as I mentioned earlier. As defined here there are two main losses for an investor in the market. The first one is a repeat of last year's negative performance. Nobody wants to do that. And the second one is missing out on a rally to recoup some of last year's losses. So staying with the theme in context it means that investors are vulnerable to chase performance and this can be in this case over-extrapolated, move in either direction to levels that cannot be fully rationalized by fundamentals. This is where the narratives take over for fundamental valuations to justify price moves. So be very wary of that. When investors hold high levels of cash, this becomes the attendant risk of holding cash. The fear that if markets start to move higher, that they start to miss out on that performance and they start to chase that performance at higher and worse levels in the market. That becomes a risk, and that's the risk-on risk, something that needs to be hedged.

Let's break this down and start to talk about bonds. Bond yields have been going down and people are looking at that and wondering what the fair level of yields should actually be. Fair levels are an academic concept that follow on rational price moves relative to fundamentals, but oftentimes markets can be irrational and as a result, markets tend not to stay at projected fair value levels for too long. Ironically this makes fair value levels very unstable, so let's just get that behind us when we talk about fair value. Perhaps then, thinking in terms of fair value may be misleading, especially in times like today, where the market is in a period of transition, transitioning from rising inflation and tighter policy to falling inflation stabilizing or even easing policy. What may matter more is how much the market may overshoot its fair value levels. Let's look at the 10-year yield to determine this or to try to think about this. Many investors are short duration relative to their benchmarks and after the year people had in 2022, particularly in fixed income at negative returns, nobody can afford to really miss out on performance. As bond prices rise and yields fall, investors will look to lock in current yield levels, which is good, but it's not good enough because they also need to participate in price performance to capture the move more fully in total return terms. As people start to worry about rates coming down, they start to buy longer duration assets, get price appreciation and can more fully get the overall total return.

So here we are again. Treasuries, let's say people can even chase returns in that space to a lot of this is because they have a lot of cash in short duration and money market related assets, pension funds are also another feature of the market. They tend to invest in long duration and they simply cannot afford to miss a move lower in yield because longer term investors like pension funds have to hedge long term liabilities and if yields move lower, they have to be able to capture that. So as we start to see bond yields fall and given the fact that there's a lot of cash on the sidelines, this starts to build on itself and we start to see money coming off the sidelines and starting to get invested into bond markets that may not be at optimal levels. It's really a feature of high cash levels that create a risk scenario for chasing returns and that's why I say risk-on or positive performance can actually be a risk that people need to hedge. This that's an important concept for 2023. Despite the possibility of the Fed hiking to 4.75 or even 5.25%, long term bond yields may ignore this because the market may interpret it as a Fed hiking into a slowing

economy that just increases recession risks and the need to cut rates later on. In other words, pivoting policy rates. That's another reason why when people see lower yields, they tend to start to chase those lower yields. We're reluctant to make a point forecast on yields. So when people ask what I think the fair value of 10-year Treasury yields are, that's always hard to determine. But for argument's sake, let's say potentially around 3.5% for the 10-year at this current juncture, maybe a little bit lower, dependent on what the data has in store for us in 2023, and something that we will need to adjust going forward. But for now, a 3.5% 10-year Treasury yield is somewhat of a balancing point for risk.

For the time being, let's call that a fair value level, but that's subject to moving. Now, on the flip side, we ask whether lower bond yields help valuations, particularly in risky assets, because it eases financial conditions. The answer to that is mathematically, yes. When one discounts future cash flows at a lower interest rate, the present value of those assets or stock prices tend to rise, and I think we're seeing that right now. One of the things that the market has taken a reprieve on is the fact that it doesn't seem like interest rates are going up very quickly anymore, at least for the time being. This is actually adding to some of the risk on features and characteristics in the markets. In other words, cash flows and earnings could slow as many expect, but one may be willing to pay a higher valuation for those cash flows because interest rates are actually falling. Those cash flows actually represent more value in a lower interest rate environment and the present value of those assets go up. That's the math behind a lot of what we're seeing today. And this doesn't prevent valuations or risky asset prices from falling altogether, but perhaps it provides a buffer for the decline. Asset prices may not follow as much as some may think. In other words, riskier asset prices may outperform expectations and I think that's what's taking place right now at this stage in early 2023. Add to this the stabilization of the US dollar and the potential reopening of China, and now the risks for a left-tail event, a risk-on event, actually starts to take form. Of course this doesn't happen linearly in time, but an intertemporal distribution of both left and right tail risks. That creates the high volatility environment that I think that we're going to be in. In other words, we have that short fat distribution with very fat tails and, and essentially that's where we are right now.

So how do we invest in this type of a market? Well, get balanced, in the sense that it's better to get balanced than to get defensive. One needs to construct a portfolio that balances both tail risks and manages to the middle. What I mean specifically by this is to construct a portfolio that is a balance of riskier assets like equities, high yield, emerging markets, non-agency mortgages and also lower risk assets like money market funds, cash, short duration and traditional core and total return fixed income that has five or six years of duration. Those are the two tails essentially that we're managing against each other. On one side, you've got the risk on the characteristics of high yield, EM, non-agency mortgages and on the other side, you're balancing that with some better quality, lower risk assets like cash, short duration and traditional fixed income. The balance of those two risks actually gives you what's more likely to be a better overall return profile. Diversifying the risks through asset allocation weights and creating an overall portfolio risk level that you're comfortable with is really the key to a balanced portfolio. That's the way that we want to approach 2023. It's a form of globally balancing the asset allocation while controlling for the risks. In other words, the goal is to maximize risk-adjusted returns.

But, one needs to be realistic about the level of risk they're willing to take on before determining their expected return. Everybody wants great returns, sure, but you also have to match that to what type of risk that you're taking on. That's just something that we all have to be just aware of, and we need to approach 2023 and beyond differently because structurally things have changed. We have labor shortages, and will likely be in a higher inflation environment. Yes, inflation is likely to fall in 2023, but what about in '24 and '25? You know, if we have labor shortages and structural issues creating a higher inflation environment, that's also going to create higher risk free rates which changes everything. One style or factor may no longer dominate returns. It's not like we could say, well growth is the place to be and let's overweight that and not worry about anything else. It's really better to be balanced in terms of trying to achieve better risk-adjusted returns. You want to balance off these risks.

The bottom line here is to keep this context in mind because it may demystify price action and highlight opportunities as the data and policy developments emerge over the next several weeks. And you know, I'm going to be talking about this much, much more in detail in a later podcast, but the idea of managing those two tail risks and balancing those risks on either side in an environment where we have high levels of cash where people are apt to chase returns, which can create a right-tail risk. The risk-on tail is something to be wary of because we could get some elevated prices in the markets that might not make all that much sense to one's longer term fundamental underpinnings, and might give us an opportunity to then move into safer haven assets to hedge those risks in case bad things do happen. But, it's really going to be about balancing and going between those two tails in 2023. And when I say you're balancing those two tail risks, you're really managing to the middle and the way we do that is by creating this diversified portfolio.

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