can you forecast the future?

Graham Bentley explains why following the risk-based approach of strategic asset allocation is a 'no-brainer' and why attempting to guess the future is not.

Graham Bentley
Head of Investment Marketing,
Skandia UK Business Unit

What do you think you know that others don't? Active investors must assume they know something other investors don't, otherwise they wouldn't attempt to be 'stock pickers'. This reasoning can also be applied to asset allocation; what do you think you know about an asset class that will lead you to forecast its performance?

Many investor pundits write to me about their 'no-brainer' solutions for getting wealthy. For instance, it is apparently a 'no-brainer' to exclude Fixed Interest in a portfolio. Conversely, other investor pundits reliably inform me that it is also a no-brainer to increase exposure to it. Another no-brainer relates to both the inclusion and exclusion of Property. The common theme behind these opinions is that the instigators of these proposals seem to be experts who can forecast the future.

I have a cunning plan that should appeal to those looking for similar no-brainer investment opportunities – buy a lottery ticket. If you had picked the winning numbers last week you would be a millionaire today. Many of you will have spotted the flaw in this plan – so why can't active investors spot the same flaw? Of course, if you'd picked the right asset class a year ago (Asia ex Japan), you would have increased your wealth by an average of over 40%*, but it is unlikely you would have had exposure to this asset class alone.

beware faulty logic

Let's take a look at that Fixed Interest 'no-brainer' and investigate the logic. First, we should remind ourselves of a key lesson of economics – that it is nonsense to judge assets in isolation. Investors who forget this can make expensive errors, as we do when we are told that Asian equities are too risky for certain investors. This is rather like ignoring flour when you're baking bread because you don't like the taste straight from the bag. The rationale presented to me for exclusion of Fixed Interest relates to the misconception that Fixed Interest securities' prices are sensitive only to interest rates. Interest rates are rising, ergo prices will fall, ergo why buy Fixed Interest? This is a no-brainer, right? Well let's just call it a half-brainer, built on faulty logic.

Fixed Interest securities are, to varying degrees, affected by interest rates, inflation and credit, or default risk. Sub-investment grade corporate bonds (generally found in the UK Other Bond

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an alternative view of the future

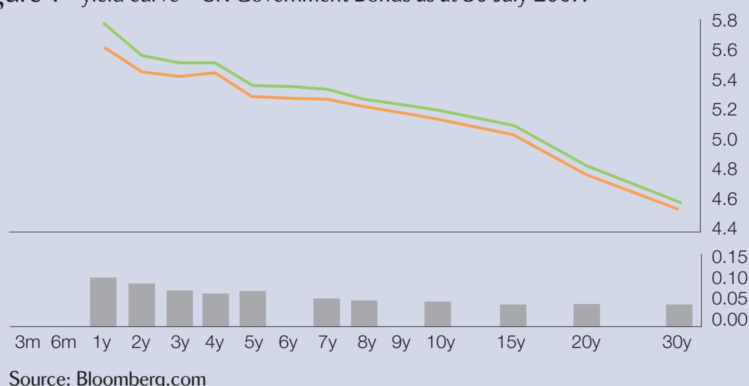
If you really do need a view of the future to support your case, then here's an alternative no-brainer. As an investor I should be concerned less with what interest rates *should* be in a year's time, but rather with where the market traders are pricing in.

Consider a beauty parade, and my attempt to predict the winner. The obvious route is to bet on the most beautiful girl in the competition, using some universally recognised 'beauty benchmarks' understood by the majority of observers. However, this presupposes that the judges' opinions of what constitutes a winning combination match the majority view. Rather, my strategy should be to find out what the judges criteria are given that they will award the prize.

Similarly, I can ignore the economic predictions of experts and use a simple model to tell me what interest rates the market is actually pricing, because that model embodies the opinions of thousands of traders who have examined millions of bits of data by plotting the yields of bonds over varying maturities. That model is known as a yield curve, and I would normally expect the curve to tell me that interest rates are higher, the longer the period over which the money is borrowed, because the lender has to bear more risks and wait longer for his capital to be returned.

The fact that the curve (see Figure 1) shows interest rates lower as maturities increase is a big signal that the market is pricing interest rate cuts in less than two years time.

Figure 1 – yield curve – UK Government Bonds as at 30 July 2007.



Source: Bloomberg.com

sector) are typically more sensitive to equity movements and associated credit risk, than to interest rates. This is because their yields are higher (to compensate for the higher default-risk than Government Bonds, or Gilts), thus the impact of an interest rate rise is proportionately less than it would be on a lower-yielding gilt with an equivalent maturity.

Simplistically, a 1% rise in interest rates equates to a 20% rise in a 5% coupon, but only a 10% rise in a 10% coupon. Price falls are therefore similarly proportionate. An example of this difference in behaviour can be seen in relative performance of Fixed Interest sectors. Over the two years to end of June 2007, investment grade corporates and gilts have lost money for investors, while lower quality bonds eg UK Other Bond funds, have returned more than Cash.

However, there is another risk that Fixed Interest is sensitive to – event risk. In times of uncertainty undiversified investors fly to quality and safety. Recent equity setbacks have seen Gilts and their index-linked equivalents gaining more than 4%, while corporate bond prices have fallen back. And this, remember, is against a background of apparently rising interest rates.

risk-based approach

We should also bear in mind that strategic asset allocation is a risk-based approach. It attempts to use various asset classes in order to cancel out peaks and troughs of price movements. To re-emphasise, a holding of Gilts would have been very gratifying over recent weeks.

All in all, it is relatively easy to construct a completely opposing argument to that which would suggest excluding Fixed Interest, if returns were our only consideration. But they aren't. In the final analysis, if predictions are so easy to create and justify, then rules for portfolio construction have to ignore them. We should ignore claims to powers of foresight, instead explaining to investors how we manage the risk-return trade-off and be open about the risks we expose them to. Now that *is* a no-brainer. ■

If you have any feedback on this article or any topics you would like to see covered in future issues, please e-mail Graham at **graham.bentley@skandia.co.uk**

*Source Financial Express Analytics: Asia Ex Japan sector average return 12 months to 30 July 2007.

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Phone: +44 (0) 1624 655 555 Fax: +44 (0) 1624 611 715

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