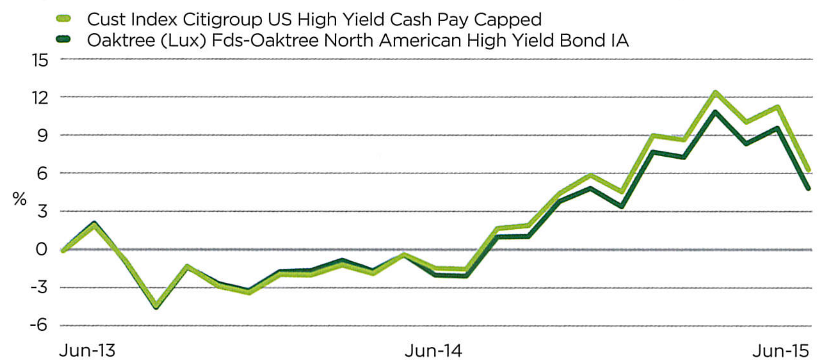
RISK ASSETS HAVE SURVIVED TWO WORLD WARS, SO CAN COPE WITH GREECE

Holders of risk assets have been rewarded for years, despite a backdrop of ongoing crises, financial or otherwise, says Credo CIO Dean Gouws



Deon Gouws, CIO
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In his book *The Global Minotaur,* former Greek finance minister Yanis Varoufakis used the Minotaur of Crete as a metaphor to describe the surplus recycling process in the post-Bretton Woods era.

In the same way that Athens had to send periodic tributes into the labyrinth to appease the Minotaur, Germany, Japan and China (who were running a trade surplus with the US) would recycle these exports through tributes of capital to the labyrinth of Wall Street.

This capital refinanced the US deficit and propped up consumer demand for those exports, thus completing the surplus recycling mechanism that continued for decades until the crisis in 2008.

We can apply this same metaphor to the current investment landscape. Born from the romance between the investment industry (the process of allocating savings into investment) and journalists (who are incentivised to generate attention-grabbing content), the fear induced by the financial media is the global Minotaur at the centre of capital markets today.

Investors pay tributes to satisfy the Minotaur in the form of increased portfolio turnover, cash drag, expensive hedging and a general loss of confidence in financial markets.

The fear drives investors deeper into 'macro tourism' and the complex labyrinth of charlatans selling macro research, high fee 'thematic' funds and leveraged short ETFs. This 'newsflow-induced turnover' creates the price volatility that feeds more subject material to the monster... and our capital recycling loop is complete.

Yet it is the existence of these tail risks and the perpetual irrational behaviour towards them that creates opportunities for a long-term investor.

Humans are hard-wired to avoid having exposure to fat left tails and chances of large losses more than we are to reach for large gains. As our ancestors evolved to avoid lions on the savannah, we are prone to evading investments with returns that display negative skewness.

Capturing risk premium

An asset class with one of the most negatively skewed distributions is high yield debt, with steady positive coupons during most of the cycle and much larger default losses in the downturns. Taking the other side of this behavioural bias is a way for our investors to capture this risk premium.

But that is not to say we are naively taking on tail risk. Through Oaktree North American High Yield, we have a way to access this premium with reduced tail risk. Over a 29-year track record the team has averaged an annual default rate a third of the index, with a fifth of the loss rate.

And while short-term momentum has been negative for the asset class, valuations are around long-term averages (more than you can say for a majority of major asset classes in recent years) and the carry is attractive on a relative basis.

Are 'Chinageddon' and 'Grexit' going to cause a permanent loss of capital to long-term investors? Or are they going to go quietly into the night like the millennium bug, the US debt ceiling, the fiscal cliff and Ebola?

We don't know the answer but history has shown that despite two world wars, three separate collapses of the international monetary system and a myriad of financial crises, holders of risk assets have been rewarded for the last 100 years.

As long as the Minotaur continues to roar, there is no reason to believe investors will become so rational as to extinguish the fear premium that has rewarded risk taking long before quantitative easing or the eurozone existed.

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