CREDO WEALTH

Risky Risk-Free

Investment management is as much about risk control as it is about seeking returns. The overly simplistic idea that you get paid for blindly taking risk is not true. It makes for pretty mathematics with a switch between ‘risky’ assets (like equity) and ‘risk-free’ assets (like cash and government bonds). As fundamental investors, we are more concerned with what the underlying asset actually does. In the long term, you don’t get paid for the risks you take (intentions), you get paid for the tasks you complete successfully (value creation).

Risk is not purely quantitative – it can’t be summarised into a single number. Like the discussion of GAAP accounting measures last month, numbers are an attempt to make complication comprehendible. However, they often raise further questions. As an example, you can compare valuations to high points, low points, and long-term averages. The current S&P 500 price-to-earnings ratio (18.3), for instance, is at its highest level since 2002 and higher than its 20-year average (16.6).

You can make adjustments to try and assess a more ‘normal’ long-term measure. Professor Shiller of Yale University proposes a price-to-earnings ratio measure that uses 10 years’ average earnings. That measure still depends on the start and end point, with the environment changing. It is almost 10 years since the uncertainty of the Financial Crisis was unleashed. Still, with earnings not having kept up with the market rally, Shiller’s question is shouting. 29 compared to an average of 17 for over a century for which we have data, begs for caution.

The answers are unequivocal: equity valuations are very high in absolute terms on almost any measure. Yet one would’ve come to the same conclusion 2 years ago, and if you’d held cash over this period you’d have underperformed materially, missing out on the rally in equities.

Our sense for why equity valuations are extended has to do with “financial repression” being carried out by central banks. The “yield” (earnings yield, rental yield, etc.) that investors are prepared to accept on “risky” assets (equites, real estate, etc.) is directly related to what they can get on (perceptibly) “risk-free” assets such as government bonds or cash. Simply put, anything valued with an artificially suppressed interest rate, so too will be overvalued.

The numbers clearly show that risk-free assets are in a bubble. Consider that over the past 60 years, the real risk-free yield on government bonds (10-year US treasuries) has averaged ~2.5%, however, since the 2008/9 financial crisis that yield has consistently been below 1%. The reason is that central banks have been purchasing government bonds with the explicit goal of suppressing yields (“quantitative easing”). Meanwhile the real risk-free yield in the money market (3 month US T-Bill) has averaged ~0.85% over the past 60 years. However, since the 2008/9 financial crisis that yield has consistently been below -1%, implying that in saving in the money market one must accept an erosion of purchasing power! Similarly, central bankers have been suppressing short-term money market rates.

What does one do? We know that in the near term, timing the market is a fool's game. That said, over the medium term, we remain cautious since much of the rally has been driven by a valuation re-rating (lower earnings yield) as opposed to earnings growth. Valuations are currently elevated as a result of accommodative monetary policies since 2008, meanwhile the US federal reserve has tentatively started tightening, albeit modestly and reluctantly.

Our view is that one needs to be cautious whilst things look 'frothy'. We look for cheap, contrarian sectors and stocks, which are generally less susceptible to a sharp valuation de-rating. While the market is more focused on the 'here and now', sentiment should improve for these out of favour stocks over the medium term (improving their rating).

Numbers have value because they make abstract concepts comparable. Price helps you compare Apples and Oranges. But if you then forget to look beneath the numbers, great distance can grow between reality and the story the numbers tell. Believing you can choose between risky and risk-free isn't risk control. Building conviction in the underlying businesses we hold, even if they are unloved, helps us navigate the uncertainty.

Important Notice