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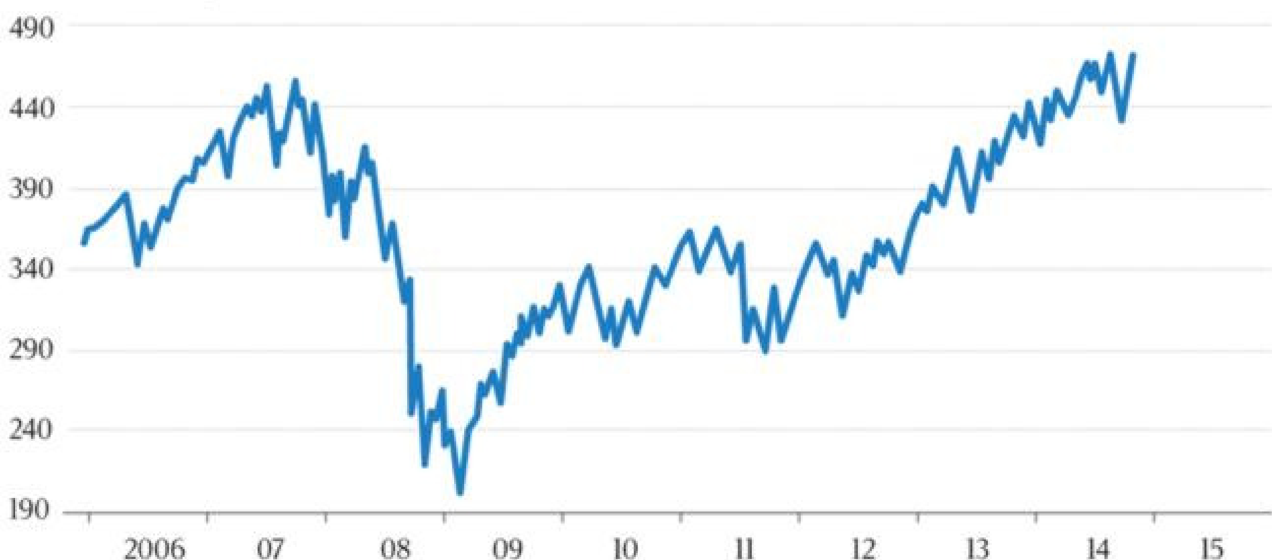
Be wary of asset value distortions

STIRLING LARKIN THE AUSTRALIAN NOVEMBER 29, 2014 12:00AM



Global equities. Source: TheAustralian

INVESTMENT managers traditionally used to employ a fairly simple technique to break down the investment universe to their clients — cash and bonds were safe assets, property represented a slightly riskier class of investment, while shares were the investment with the highest level of risk.

Typically, an investor would invest their money across these three different classes of asset in a way that best suited their investment goals and circumstances in life.

By diversifying their investments, the investor could relax, safe in the knowledge that if one group of investments did not perform well, the others would take up the slack, ensuring consistent returns.

Since the great recession of 2008, however, a fundamental and worrying change has taken place in that valuations in certain asset classes have become distorted. These distortions are rolling from one asset class to the next in an almost predictable fashion, creating an investment "megatrend" of sorts.

This pattern helps us to understand why US subprime credit market mispricing in 2008 so dramatically affected European bond market valuations in 2012 and, arguably, developed equity market metrics today.

These distortions also appear to be rolling at an accelerated pace. Even though new technologies such as high-frequency algorithmic trading and unconventional monetary policies such as quantitative easing may partly explain this new tempo, they cannot account for why these valuation mismatches are moving across asset classes and geographies.

In particular, Australian ultra-high-net-worth investors (UHNW) — who are often the recipients of the world's leading multi-asset investment advice — now proactively manage their portfolios in anticipation of these megatrend movements and do so with the relative advantage of allocating across asset classes with comparative ease and speed.

Wary of distortions in recent global bond markets, many of these globally minded investors have heavily reallocated towards global equities, particularly the US S & P 500 and Japanese Nikkei 225 bourses.

Michael McKenzie, of Britain's University of Liverpool Management School, believes that we are living in an era of unprecedented government intervention in the financial markets.

"This effectively means that we need to tear up our standard finance and economics textbooks to understand what is going on," he says.

"In many respects, the current circumstances remind me of events in 1969, when Warren Buffett, a staunch advocate of traditional value investing, announced that he no longer understood the market and closed his extremely successful hedge fund."

In explaining this megatrend, McKenzie goes on to explain: "Asset classes used to largely do their own thing, but now there is a super-cycle emerging, whereby heavily indebted investors' relentless pursuit of wealth in a near-zero interest-rate environment has driven all asset values up.

"There is a lot of talk in the media about bubbles, but I don't like the use of this word as it suggests a fairly linear process of price inflation followed by a rapid and sudden price fall.

"The Australian housing bears have been predicting this popping of the bubble for quite a while and have repeatedly ended up with egg on their faces."

As recent Nobel laureate Robert J. Shiller pointed out, speculative bubbles are neither linear, nor predictable. As long as there is a narrative to justify the upward trajectory, it will persist.

Those comments coincide with news that the next stage of this megacycle is playing out with the announcement this week that the MSCI All Country World Index — a benchmark of global equities priced in local currencies — had reached an all-time high and did so at record velocity.

The question has now become whether global equity valuations are merited or whether they, too, have succumbed to valuation distortions.

According to Deutsche Bank, a leading global multi-asset wealth manager: "Global equities have rallied back quickly from the mid-October pullback, taking the ACWI to new highs.

"The continued handy outperformance of equities over other asset classes since the GFC, up 135 per cent from the 2009 lows, in a global recovery where growth and earnings concerns have remained elevated, inevitably raises questions about valuation." The bank adds: "Underlying the recovery in global equities has also been a pattern of persistent regional divergence running on for four years now,

with US and Japanese equities outperforming the ACWI significantly, Europe and emerging markets underperforming, in turn raising questions about relative valuations." On the question of relative valuations, Michael Cembalest, chairman of market and investment strategy at JP Morgan, says: "One of the more consistently profitable decisions to make as an investor over the last 25 years has been to be overweight US versus Europe and Japanese equities."

According to Cembalest: "This approach delivered consistent excess returns, with the only prolonged exception being the 2004-2007 period, when the ill-fated southern European consumption boom was in full swing.

"While some comparisons between Japan and Europe are overblown, this much is true: lumping them together in a regional barbell has made (investment) sense."

In accepting these patterns, we must first acknowledge that traditional models that operated with different asset classes managed within distinct silos are now evolving across the industry towards automated methods, which embrace electronic trading platforms that trade multiple asset classes from a single screen.

Such new synergies can help explain to some degree why seismic events such as the global financial crisis, Greek government bond crisis and last year's "Taper Tantrum" (how markets reacted to the prospect of the Fed tapering the rate of bond purchases) spread contagion faster than ever before.

But, in ensuring that what we are looking at today does not become the eye of tomorrow's storm, it is imperative to remember that it is not only important to question valuation mismatches within asset classes but across them as well.

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