global matters weekly

momentum

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Steering clear of losses

by Lorenzo La Posta

Financial losses come in many shapes and forms and investors rightly spend a considerable amount of time worrying about them but managing loss aversion poorly can make the long-term outcome even worse. It is important to pick the right battles, to trade off cost of protection with loss severity and to not lose sight of the ultimate investment goals.

How people perceive financial losses and how they would behave pre-emptively in the expectation (or fear) of potential drops in their portfolio value is highly personal, as it depends on a combination of experience, emotions and personality. However, we, in our aim to act as rational investment professionals, focus on understanding three things: how a potential risk affects the long-term performance versus the objective, what can be done to reduce the chances of this happening and how its cost compares to the long-term benefits.

> *"The impact of losses must be measured across two dimensions: space and time"*

The impact of losses must be measured across two dimensions: space and time. The deeper the loss or the longer its duration, the more the portfolio will have to recover from a drawdown to achieve its investment goal over the investment horizon. It's intuitive, but here is where the first irrational behaviour appears: people tend to be more afraid of an overnight 30% crash than one of similar depth but spread over, for instance, 2 years. The former is more extreme and highly unusual, but the latter is more detrimental to long-term returns as it not only erodes capital, but time too.

> *"Long-term destruction of capital can be mitigated, or even avoided, by effective asset allocation and diversification"*

Long-term destruction of capital can be mitigated, or even avoided, by effective asset allocation and diversification. Asset classes such as defensive equities, high yield bonds or emerging market debt can help mitigate equity risk without significantly affecting the overall portfolio expected return, while government bonds, cash, gold or liquid alternatives can offer even lower correlation to risk assets, with the main drawback being lower long-run expected returns.

Extreme, sudden losses, such as that which global equities experienced earlier this year (-34% in USD in just over a month), are instead very hard to completely hedge against as they are often accompanied by a lack of liquidity and widespread selloffs across most asset classes, dramatically reducing diversification benefits. One of the few effective ways of protecting capital (or even posting substantial gains) during sharply falling markets is by betting on an increase in volatility via put options or via futures on volatility indices. For instance, buying short term futures on the CBOE Volatility (VIX) Index would have returned +300% during the Great Financial Crisis and +350% during this year's rout. Similarly put options can be used to cap the maximum loss a portfolio can suffer. The caveat is that these strategies are very expensive and tend to bleed value every day that such wide moves do not happen: the same volatility-buying strategy has indeed lost 40% per annum, on average, since Dec '05 to today. Therefore, continued long volatility exposure makes financial sense only when driven by a short-term negative view on equity markets and a fair assessment of costs and benefits.

> *"we spend a lot of time considering downside risk scenarios"*

At Momentum, we spend a lot of time considering downside risk scenarios and always strive to provide our clients with a more stable journey toward their goals. Our multi-asset, multi-strategy portfolios offer ample breadth along with genuine diversification and are strategically built to offer the best expected long-term outcome given a certain risk profile. On an ongoing basis, though, we also assess market conditions and shorter-term dynamics and tilt our portfolios accordingly, always mindful of costs, potential outcomes and, of course, the chances of our views being wrong.

Market Focus

» Tensions between the US and China continued to rise

» Equity markets fell as hopes of a V-shaped recovery diminished

» Brent crude rose 4.9% ending the week at $32.5 a barrel

» Gold rose 2.4% ending the week at $1743.7 an ounce

US

» The Trump administration announced that any chipmaker using American equipment cannot supply Huawei without prior approval.

» US equities fell by 2.2% over the past week as talks of a V-shaped recovery waned.

» The Federal Reserve's ETF purchases supported the investment grade bond market, returning 0.7% over the week.

» The Commerce Department reported retail sales (excluding auto sector) fell by 17.2% in April, roughly twice the expected fall and the lowest on record.

» The US Consumer Price Index (CPI) fell by 0.8% in April, due to falling costs within energy and transport outweighing the sharpest increase in grocery food prices since 1974.

Europe

» The Italian government approved an economic stimulus package worth €55 bn that uses a mix of measures such as tax breaks and grants for businesses and households.

» Tension over the German constitutional court ruling that could impact the Bundesbank's inclusion in the ECB's stimulus program showed little sign of abating.

» European equities fell by 3.5% over the past week whilst their emerging Europe counterparts fell by marginally less at 2.2%.

UK

» UK GDP growth fell by 2.0% for the first three months of 2020 after showing no growth for the last quarter of 2019.

» Brexit talks regarding the relationship between the UK and the EU following the UK's departure from the union continued last Monday.

» UK equities joined most other equity markets in the red over the past week at -2.2%. The UK is still the developed market laggard on a year to date basis, down -22.6%.

Rest of the World/Asia

» Japan's PM ended the state of emergency in 39 out of the country's 47 prefectures, lifting the stay at home order two weeks earlier than previously expected.

» Chinese economic data for April beat expectations. The country's industrial production rose 3.9% year-on-year thanks to stronger than expected export demand.

» Global emerging market equities fell by 1.1% over the past week, whilst emerging market bonds returned 1.0%.

Asset Class / Region	Currency	Cumulative returns Week ending 15 May	Month to date	YTD 2020	12 months
Developed Markets Equities					
United States	USD	-2.2%	-1.6%	-10.9%	1.9%
United Kingdom	GBP	-2.2%	-1.5%	-22.6%	-18.2%
Continental Europe	EUR	-3.5%	-3.1%	-18.6%	-8.9%
Japan	JPY	-0.3%	-0.7%	-14.5%	-3.3%
Asia Pacific (ex Japan)	USD	-1.0%	-2.5%	-15.1%	-6.0%
Australia	AUD	0.3%	-2.1%	-18.1%	-10.7%
Global	USD	-2.5%	-2.0%	-14.2%	-3.1%
Emerging Markets Equities					
Emerging Europe	USD	-2.2%	-3.3%	-32.3%	-16.0%
Emerging Asia	USD	-0.7%	-1.9%	-12.3%	-1.5%
Emerging Latin America	USD	-5.1%	-7.7%	-46.6%	-38.7%
BRICs	USD	-0.8%	-2.1%	-16.5%	-5.9%
China	USD	-0.2%	-0.2%	-4.7%	4.2%
MENA countries	USD	0.0%	-4.5%	-22.3%	-19.7%
South Africa	USD	-3.5%	-2.3%	-34.2%	-33.5%
India	USD	-1.7%	-8.1%	-29.2%	-23.1%
Global emerging markets	USD	-1.1%	-2.5%	-18.7%	-8.9%
Bonds					
US Treasuries	USD	0.5%	0.0%	9.5%	14.1%
US Treasuries (inflation protected)	USD	0.2%	0.1%	5.0%	9.7%
US Corporate (investment grade)	USD	0.7%	-0.7%	0.7%	8.7%
US High Yield	USD	-0.7%	0.0%	-8.8%	-3.4%
UK Gilts	GBP	-0.6%	-0.6%	9.9%	14.5%
UK Corporate (investment grade)	GBP	-0.9%	-1.0%	-0.3%	5.5%
Euro Government Bonds	EUR	-0.1%	-0.7%	0.2%	4.1%
Euro Corporate (investment grade)	EUR	-0.5%	-1.0%	-3.6%	-1.4%
Euro High Yield	EUR	-0.7%	-1.4%	-10.9%	-6.0%
Japanese Government	JPY	-0.1%	-0.4%	-0.5%	0.1%
Australian Government	AUD	-0.1%	0.0%	3.9%	7.0%
Global Government Bonds	USD	-0.4%	-1.0%	3.1%	7.1%
Global Bonds	USD	-0.3%	-0.9%	1.1%	5.3%
Global Convertible Bonds	USD	-1.4%	0.7%	-2.8%	2.8%
Emerging Market Bonds	USD	1.0%	2.2%	-5.8%	0.3%

Source: Bloomberg. Past performance is not indicative of future returns.

		Cumulative returns			
Asset Class / Region	**Currency**	**Week ending 15 May**	**Month to date**	**YTD 2020**	**12 months**
Property					
US Property Securities	USD	-9.1%	-10.7%	-29.7%	-25.4%
Australian Property Securities	AUD	-2.0%	-3.2%	-28.2%	-26.8%
Asia Property Securities	USD	-4.9%	-5.6%	-21.9%	-18.1%
Global Property Securities	USD	-7.0%	-8.1%	-28.4%	-22.3%
Currencies					
Euro	USD	-0.4%	-1.2%	-3.8%	-3.6%
UK Pound Sterling	USD	-2.4%	-3.7%	-8.6%	-5.8%
Japanese Yen	USD	-0.6%	-0.3%	1.2%	2.0%
Australian Dollar	USD	-1.9%	-1.7%	-8.7%	-7.5%
South African Rand	USD	-1.2%	-0.3%	-24.7%	-23.4%
Swiss Franc	USD	-0.3%	-0.7%	-0.7%	3.7%
Chinese Yuan	USD	-0.4%	-0.5%	-1.9%	-3.2%
Commodities & Alternatives					
Commodities	USD	0.3%	4.9%	-33.3%	-31.1%
Agricultural Commodities	USD	-0.4%	0.4%	-13.3%	-7.3%
Oil	USD	4.9%	28.6%	-50.8%	-54.7%
Gold	USD	2.4%	3.3%	14.5%	34.3%
Hedge funds	USD	-0.1%	0.0%	-4.2%	1.5%

Source: Bloomberg. Past performance is not indicative of future returns.

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