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Drawdown risk rising

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By 5pm on Wednesday last week, Bitcoin had lost 30% of its value from its bid that morning. Before the day was over, it had bounced 30% off that low.

This article is not about cryptocurrencies. Instead, we want to talk about why drawdown risk, across asset classes, might be on the rise. Then we discuss how such a paradigm impacts the retail investor, and what they can do about it.

The tribes are speaking

Human emotion often gets in the way of rational behaviour.

When are our emotions strongest? It's debatable, but our 'tribes' (political parties, religions, cults, sports teams, etc.) are particularly important to us. History is littered with examples of people doing astonishingly irrational and sometimes tragic things under the influence of a group they feel they belong to.

Look in every corner of the world and you'll see evidence that the pull of the tribe is getting stronger. Digital communities make it easier than ever to rally people behind a cause no matter the quality of its substance, with social media algorithms putting just the right content in front of the individual to make them believe.

Markets are not immune to tribal behaviour. The GameStop fiasco is the quintessential example, but there's evidence of similar hubris in other, more mainstream equities. Be under no illusion, Elon Musk has a tribal following.

In the context of investing, tribes are problematic because their members, who can congregate in great numbers, often shy away from asking the hard questions that would evoke a more measured approach. Look no further than the story of Elizabeth Holmes and her now defunct biotech company, Theranos, for evidence of this phenomenon; she raised billions of dollars for a product that never worked.

And here's the crux of the matter: the collective hubris of a 'tribe' has the power to drive asset prices way beyond their fundamental values. This development has many ramifications. Increased drawdown risk is an important one.

Why you need different thinking

At first glance, it might seem that Bitcoin investors came out even last Wednesday – 30% down, 30% up. No worries, then. But as any investor familiar with the mathematics of the downside will tell you, it actually needed to bounce 50% to recover the losses it had accrued through 5pm.

In words, it's very difficult to recover from large drawdowns. This is true not only in a financial sense, but also on an emotional level. The psychological consequences of suffering large drawdowns, in an individual asset or portfolio, can extend to the following:

- Loss of faith in a financial plan leading to heightened stress around financial security
- Permanently diminished appetite for the risk needed to reach investment goals
- Excessively risky behaviour to try make up for losses

It's a non-exhaustive list. But those three outcomes alone should be enough to reiterate the importance of avoiding what investment managers refer to as 'bombs'. The difficulty, of course, is that we all suffer from FOMO – staying on the sidelines when an asset or asset class is generating mouth-watering returns is very, very difficult, even when the risk is evident. This psychological pitfall is common to all investors, professional or not.

If tribe-like investing becomes a market mainstay, the frequency of explosive returns is likely to increase, along with the temptation to get involved. To be sure, there's space enough in most portfolios to indulge our FOMO to some extent. But that must be done in tandem with true diversification to avoid life changing drawdowns.

The hedge fund advantage

As a long-only manager, you have an inherent desire for asset prices to rise because that's the only way you can make money. Through that lens, the concept of risk has a negative connotation because adhering to its strictures often results in leaving returns on the table. What most hedge fund naysayers miss is that the very notion of being able to benefit from falling asset prices brings about a much deeper and healthier relationship with risk.

Investment products that don't prioritise risk are prone to positioning themselves in hard-running market darlings. In other words, they invest with the crowd. This is born out in the strong correlations that many traditional investment products have to the overall market.

Hedge fund managers, on the other hand, are always thinking about what could go wrong; they can make money when things do. It's nuanced, but that mindset makes them less inclined to pile into crowded trades. In fact, they might go directly against them. That emphasis on risk is how quality South African hedge fund managers think – it's simply a myth that the portfolios they run are riskier than traditional long-only products.

To be absolutely clear, we are not chastising investment products that correlate to the market. Every portfolio needs them, most in size. What we are trying to drive home is that true diversification cannot be achieved if all the underlying managers want asset prices to rise. Some level of convergence is inevitable under such a scenario, and that increases drawdown risk.

How to shop for a hedge fund

It follows that when considering a hedge fund, it's their performance during weak/volatile markets that you should home in on. If asymmetric returns – where their participation on the downside is limited – are not visible, then they might only be dressed as a hedge fund.

Spend some time getting to understand the different hedge fund strategies on offer. With that knowledge, you'll more easily be able to see how they can bring true diversification to your overall portfolio. Any hedge fund manager worth their salt will be able to help you with this exploration. Most will be willing to do so.

Finally, be aware that South African hedge funds have taken steps to address the issues of cost and accessibility that acted as legitimate hurdles for many investors. They are becoming more user-friendly, and we expect that trend to continue.

Why is now a good time to hedge?

Traditional asset classes have had the support of low and falling interest rates and giant stimulatory fiscal packages since the 2008/09 financial crisis. This has pushed global equity and bond valuations near to their all-time highs. Sure, there are pockets of palatable valuations, but the large sectors that drive beta, like tech stocks and developed market bonds, are fully priced.

If history is anything to go by, it's feasible that future returns from these traditional asset classes might be subdued.

As a base case, equity markets look poised to tread water as the underlying fundamentals (read earnings) grow into their punchy ratings. In fixed income, a rise in yields looks likely given the strong global economic growth that is forecast. Of course, there's also a bull case where growth continues without inflation becoming a problem, and a bear case, where it does.

Either way, South African hedge fund managers will see opportunity. They have the tools and risk management prowess to perform in sideways or falling markets; at worst they'll limit drawdown risk for a portion of your capital; at best they'll generate positive absolute returns, no matter how crazy the tribes get.

Glacier Research would like to thank Marthinus van der Nest for his contribution to this week's Funds on Friday.

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