
Robeco Summer Sessions

Session 2:

Risk and return after the crisis

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interviewed by Brendan Maton, financial journalist**

Risk and return after the crisis

Is the real lesson from this crisis that liquidity was the big problem?

Liquidity was not the only problem. But I think a lesson that investors have to derive from this crisis is that it is very important to be aware of what your liquidity situation or the liquidity situation of your portfolio is at any given point in time. I think some investors have learned the hard way that it is not the same thing to invest in an equity vehicle that is liquid versus an equity vehicle that is illiquid. And if you also have an illiquid portfolio and are going to have to sell it into an illiquid market, as has been the situation for many investors in the current crisis, then you yourself are going to find that you need to sell your assets at a time when you are not going to find buyers who are willing to maybe buy those assets at what you think should be the fair value of those assets. This leads to forced sales. And that leads to big losses for the investors who are forced to sell. So I think what prompted the crisis were obviously fundamental factors, and that one of the consequences is that those investors who had not properly thought through the liquidity exposures in their portfolios were among the investors who suffered the heaviest losses, or who were in the worst situation in this crisis. So yes, I think one of the big lessons from the crisis – and I think the investors are taking notes – especially for institutional investors, is how to think more carefully about whether you are long or short liquidity. And it seems like being short liquidity a little bit too much can have disastrous effects in a situation such as the one we lived through at the end of 2008 and the beginning of 2009. Yes.

We have seen a lot of famous investors with fairly illiquid portfolios (real assets, but illiquid portfolios) lose a lot of money. Do you think that this type of investor, like the Yale Endowment Foundation, remain a good model or is the model in need of change?

The model remains a model to think carefully about. I do not think they are going to change their model. I think essentially their model is sound, a model based on diversification across asset classes. It is a model where, as a long-term investor, you think carefully about whether you can assume some illiquidity. As I said before, liquidity is important. But you need to calibrate depending on your needs how much illiquidity you can assume. And certainly these investors have been liquidity providers in the past, and I think they are going to continue doing so, because they can afford to do so, given their long-term investment horizon. Now, what we are going to have to think more about is – what is the risk exposure that we have in these portfolios? One way in which investors are going to start thinking more carefully – maybe these are too limited or simplistic interpretations of what they do – is to think: I am going to invest a fixed proportion in certain asset classes that are going to be defined in a very rigid way, and I am going to invest 10% in this package, 5% in that package, and these will always be invested in that way. I think that is not exactly what they do in practice; that is the way it has been interpreted popularly. And that way of investing might be a little bit misleading. Because we have a lot of overlapping in the risk exposure of some of these asset classes, and when you do not think through the veil of the asset class, and go a little bit beyond that, you think more deeply about the risk exposure. That is what I think investors are going to start thinking about. And thinking about what fundamental risk is relevant to me as an investor, and then what kind of exposure do I want to have to those risks, or dealing



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with my risk tolerance given my liabilities. And then to think more carefully about: Given that I decide to have risk exposure of, say, 20% to that specific risk class, how do I implement that? And maybe I can do that throughout different types of asset classes. One class could be public equities; one could be through private equities, or through this or the other type of asset class. So I think that is a lesson we have learned from this. I think that is something that endowments, or at least the most sophisticated endowments, and others were actually doing, and are doing. And what is going to go away is the more simplistic interpretation of what they were doing.

How do you recommend that investors measure risk going forward?

There are going to be three things they need to think about. One is fundamental risk, and the risks that are relevant to me as an investor. Investors have been typically ignoring in many ways what their portfolios are supposed to finance. So if you are a pension fund, the structure of what your portfolio has to finance is fundamentally different to what it is if you are an endowment. You have lots of different issues that you need to be aware of, your expenses look different over time, and they are more or less flexible. And given that you need to think about what the risks are on my liabilities side, and how much tolerance do I have in relation to those risk. So I think the investors are going to start thinking more carefully about that. And risk is what they really need to think about; one form is inflation risk, another is what they would call long-term-growth risk. This would be similar somehow to stock-market risk. And another one is investment risk. What kind of real interest rates am I going to get at any given point in time as I roll over my investments? And these three risks are there, but the exposures you want to have to these three risks are going to be different depending on what kind of investor you are. A short-term investor probably has to pay more attention to long-run-growth risk, because they cannot afford to be there for the long term. A long-term investor is probably more tolerant of long-run risk, inherent in the stock market, but probably less tolerant of things like inflation risk, or real-interest-rate risk. And they are going to have an interest

hedge in those risks, particularly Euro pension funds, for instance. So that is another lesson we are hopefully going to learn from this crisis. We need to be more careful in thinking about the fact that there is not just one single type of risk, there are several types of risk. And how do I want to manage my exposure to each risk. To do that, I really need to think very carefully about what the whole objective of this pool of funds I am investing in is. In other words, whether it is this pool of assets that is supposed to be financed. And pension funds are not the same thing as endowments. Their liability is very different. And so that might have driven people's way of thinking about how they invest their assets.

Can I ask you what investment opportunities you see after the credit crunch?

I would like to distinguish along two dimensions. One is the dimension of: I think it is probably time to go back to basics. I think many analysts will agree that equities were probably highly overvalued in the last ten years or so. Then, after the bear market we had after the bursting of the internet tech bubble, valuations did not come back to what most analysts would consider normal by historical standards. And after the crunch, the liquidity crisis and the financial crisis in 2008, equity is now back to levels that are fair – probably not extremely cheap, I do not think they are – but they look fairly valued. So for long-term investors like young investors savings for retirement, or institutional investors such as endowments or foundations, this basic traditional asset class now looks like an attractive asset class where you can go back to making normal allocations. So one type of investment opportunity is: let's return to normal. And, in a way, for young investors, these are good times, because now those are the asset classes available to you. And these asset classes finally look attractively priced to those investors. And secondly, we had huge disruptions in the market last year, and that has created a lot of opportunities, quite frankly, in the fixed-income markets, and other types of markets. And for those investors who are not afraid to go back into alternatives, this is probably not a bad time either. You want to take advantage of those opportunities. One example is convertible arbitrage, for instance.

This performed terribly badly over the last two years, and the opportunities offered by these strategies are now very big, mostly because of the capital outflow away from them. In this way, they have created opportunities for capital that is not afraid to come back in.

Do you see any bubbles out there in the investment world?

Some people would say, if you believe inflation is going to come back, there is a huge bubble in one market, and that is the treasury market. And in fact, although people do not realize it, we have seen this bubble bursting in the last few months. If you have invested in treasury bonds with very long duration, such as, for instance, 30-year treasury bonds, interest rates have been coming back lately, and losses on that particular segment of the market have been as big as the losses in the stock market, with minuses of about 30%. So there might be a bubble coming in – the excess-liquidity demand we have seen driving the prices of US treasury bonds in particular, and government bonds in general, extremely high. And are these high prices sustainable? I think we are getting some indication that these might not be sustainable, and that interest rates might go back to normal levels, or even higher if inflation picks up. And in that case, investments that did so well last year might be terrible investments going forward. So, again, diversification matters. If you are now only invested in treasury bonds because you now think that this is the safest asset class, but you might be in for a nasty surprise.

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