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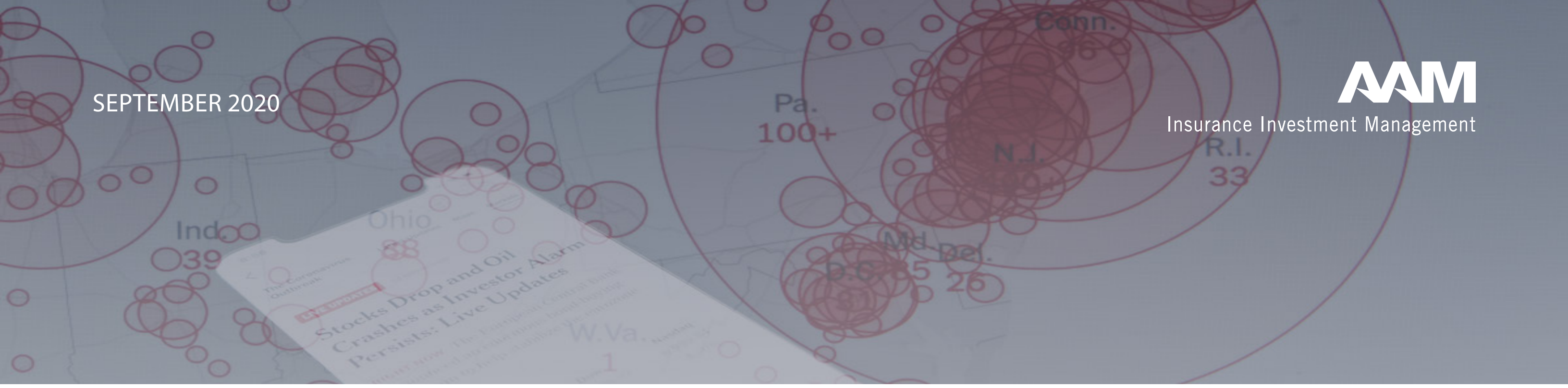

Asset Allocation Lessons of the COVID-19 Crisis

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It's been an active year for markets. At AAM our asset allocation philosophy remains unchanged: that tolerance for investment risk should be periodically defined through a rigorous ERM process, and targeted to levels that will allow an insurer to weather stress events without forced sales and realized losses. Price volatility on risky assets should be viewed as part of an ordinary market cycle, even when prompted by unpredictable events. Still, we draw a number of lessons from the experiences of the year:

Monetary and fiscal easing have compressed market risk, not eliminated it

Since mid 2019 the Federal Reserve's balance sheet has nearly doubled amid escalating rounds of asset purchases, rising from $3.8 trillion to $7 trillion. Aggressive stimulus programs have caused US Federal debt outstanding to rise by 14% in just the first 6 months of 2020, even as US GDP fell by an annualized 5% in Q1 2020 and a further 32% in Q2, and unemployment rose from 3.5% at year-end to 10.2% at 7/31/20. Interest rates have also dropped to historic levels, with the 10yr Treasury rate currently at 0.63%, less than half the all-time low pre-COVID.

Amid this challenging economic backdrop equities remain unfazed. After several weeks of sharp declines in the early stages of the crisis equities swiftly recaptured most of their losses (setting records for the fastest gains ever achieved within a recession), and in a scant few months had made new all-time highs despite persistent economic fragility and projections that the economy would take years to reach pre-COVID levels of employment and GDP. YTD through 8/31 the S&P 500 is up 9.7% and the tech-heavy NASDAQ is up a stunning 32.1% as mega-cap industry champions have come to dominate markets, with the 5 largest companies making up a remarkable and unprecedented 25% of S&P 500 total market cap. The small-cap Russell 2000 remains down 5.5% through 8/31, but such companies represent a shrinking share of the overall equity market.

This pattern of market declines being swiftly arrested and reversed after top-down interventions has become familiar. In late 2018 a slowing economy and inverted yield curve prompted a market selloff and led the Fed to abandon its rate-tightening program and resume easing, and equity roared back in 2019 to deliver the strongest annual return in decades. In late summer 2019 turmoil in repo markets shaved almost 200 points off the S&P 500, but these losses were quickly reversed once the Fed switched from shrinking its balance sheet to implementing a new round of asset purchases. While COVID has presented the largest crisis of investor confidence since the 2008 Great Recession, it appears the aggressive fiscal and monetary responses have once again succeeded in reigniting animal spirits and incentivizing investment risk-taking, albeit at the cost of a swollen Federal debt burden and Fed balance sheet.

This tendency of recent losses to be rapidly recaptured carries cautionary implications for investment risk management, the most important one being that investors should maintain robust risk discipline and not assume this pattern will persist forever or that market risk has been eliminated or indefinitely deferred. Interventions are capable of compressing risk, but to the extent that extraordinary debt levels, spending commitments, and money supply growth temporarily implemented to avert crises aren't unwound during periods of calm, they represent a reduced capacity to support markets in subsequent periods of volatility. Investors should bear in mind that market history holds many periods of prolonged drawdowns between market peaks (the S&P 500 first reached the 1,500 level in 2000, but didn't successfully hold it until 2013), and not assume that losses must inevitably be recouped within months or weeks. A risk asset allocation that can't be maintained if losses aren't swiftly recovered, is an allocation that's too large.

Diversification is important, but not easy to come by in a downturn

Diversification across issuers, sectors, and asset classes is one of the most powerful tools investors hold for mitigating investment risks. Insurers typically hold a core portfolio of investment-grade bonds, and a "risk portfolio" of equities, convertible bonds, high yield bonds, and other assets. While some of these risk asset classes may appear to offer meaningful diversification against each other during normal market conditions, the COVID volatility this spring reinforced another lesson last observed during 2008: that relatively risky assets tend to all suffer stress losses simultaneously regardless of their behavior during other periods. Comparing historical monthly returns of assets including Domestic Equity, EAFE Equity, Emerging Market Equity, Ba-B High Yield Bonds, Bank Loans, and CLO Equity, we find correlations ranging from 50-75%. This would seem to represent a material degree of diversification, but we also find that all of these assets had their worst two 30-day returns of the past two decades in the same periods of fall 2008 and spring 2020. Insofar as we seek to measure asset volatility primarily so we can limit it to manageable levels during stress scenarios, we conclude that these assets offer little "real" diversification when it's needed most. Asset modeling designed to measure and limit stress-case declines (as AAM's does) must take care to reflect that "normal" market correlations may overstate the diversification benefits of holding multiple risky assets during periods of systemic stress.

That said, the largest diversification benefit we find remains the longstanding relationship between IG bonds and equities (or equity-like assets like convertible bonds). The long-term correlation of monthly returns between the Barclays Aggregate and the S&P 500 is just 1.7%, offering an impressive degree of true diversification across market cycles. Holding the Barclays Aggregate since 1992 would've provided an annualized return of 5.56% and standard deviation of 3.53%, but moving 10% of your investment into the S&P 500 at the start of that period would've increased returns to 6.08% with no increase in volatility of returns. This phenomenon has been referred to for years as the "only free lunch in investing".

On a final note, when it comes to assets that provide a real hedge against market volatility it's hard to do better than long Treasury bonds; we calculate that the iShares >20yr Treasury Bond ETF has a long-term -33% correlation of monthly returns with the S&P 500 (though this spiked to -68% during the first 6 months of 2020). However, long Treasuries also bring considerable duration risk and price volatility, and may underperform for long periods during relatively unstressed market conditions, especially given the very low yields currently prevailing. I mention this not to necessarily recommend this asset as risk management tool (again, right-sized risk exposures are a better risk mitigation strategy), but as an example of what especially strong diversification actually looks like, in contrast to assets that show ~60% correlation under ordinary conditions and higher correlation during volatility.

The best protection in periods of volatility is already having a plan in place, and sticking to it

This spring saw the largest 30-day decline in equity markets in history. Daily headlines proclaimed new cities shutting down, new industries facing evaporating demand, new layoffs, and of course new COVID case and death counts. It was an unnerving time to be exposed to fixed income and equity markets, and the natural human inclination during such periods is to wonder whether to change one's strategy, whether by sharply reducing risk exposures during the selloff, or even potentially by adding assets at distressed levels that may not persist for long.

This is natural to think about, but we don't recommend doing it. "Changing horses in midstream" is one of the canonical ways psychology leads investors to underperform. The takeaway from COVID is not that risk should've been reduced in January (when it was far from clear that COVID was a material risk), or that it should've been increased in mid March (when no one knew just how bad the economic disruption would get). The lesson is instead that investment guidelines and strategy should already reflect the potential for periods of volatility, and describe how the investment manager should respond (if at all; patiently holding existing exposures is often the correct choice). Risk asset exposures should be sized to levels where stress-case volatility is bearable, and portfolios should include assets (like Agency MBS) likely to preserve their market value and liquidity during periods of economic stress.

Such periods do frequently represent opportunities to add assets and sectors at highly attractive entry points, insofar as price declines are excessive relative to companies' underlying financial strength. Once again, it's best to use periods of market calm to approve opportunistic allocations (high yield bonds are one example of an asset where capitalizing on an attractive entry point can lead to years of strong returns), so that the manager can take action swiftly when volatility inevitably arrives. Such approaches should clearly define what constitutes an "attractive entry point", and try to make the process as automatic as possible to reduce the potential for ambiguity during high-stress (in every sense of the word) market environments.

Of course, in many cases the right approach will simply be to hold one's pre-defined risk asset exposure all through volatile periods (subject to defined and regular rebalancing), recognizing that whether or not losses are quickly recouped, attempts to time tops and bottoms tend to be driven by emotion rather than rational calculation, and are a notorious source of underperformance. Having a clearly defined plan in advance provides strong psychological support to maintaining good investment discipline when it is needed most.

Conclusion

At this writing, COVID's impact on risk assets has been more comparable to the ephemeral late-2018 dip than the 2000 or 2008 declines that took years to recover from (however, interest rates remain close to the lows of the spring, and look like they'll have a more gradual recovery). This is a bright spot in a year that has been painfully short on them. We recommend that insurers use this period of market recovery to ensure their investment guidelines and asset allocation strategies are clearly defined, integrated into their internal ERM programs, and equipped to successfully respond to periods of market stress. Sooner or later another one will come, but with proper preparation they can bring prudent investors opportunities to lock in strong returns while containing losses within tolerable limits.

Data Sources

All index, investment return, and diversification impact data sourced from Bloomberg
Unemployment statistics from Bureau of Labor Statistics
GDP data from Bureau of Economic Analysis
Federal Reserve balance sheet data from Federal Reserve
All data as of 7/31/20 except as noted in the text

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