



Comfort is Rarely Rewarded; Maverick Risk and False Benchmarks

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“The loser is the trend-chasing, comfort-seeking investor. The market doesn’t reward comfort. It rewards discomfort.”

Rob Arnott

Conventional investment strategies, while affording the investor at least a temporary degree of comfort, are destined to produce mediocre results. Only by distancing themselves from the ordinary approach – as Jeremy Grantham and Seth Klarman have – can asset managers achieve superior performance and truly fulfill their fiduciary duties by acting as proper stewards of their clients’ capital.

In Rob Arnott’s November 2010 piece, [The Glad Game](#) he asks investors to consider “maverick risk” as an important driver of investment outcomes:

There’s conventional volatility in returns, which introduces a risk of poor investment returns. There’s the asset/liability mismatch, which leads to a risk that we cannot cover our future obligations. And, there’s maverick risk, in which investors choose a different path than their peers, exposing them to criticism, especially when performance suffers. All three risks are hugely important. Yet, we typically focus our analytics on the first of these, simple volatility, and our behavior on the last of these, maverick risk.

The idea of maverick risk is a compelling one. From a human behavioral standpoint, we are conditioned to think of being outside of the herd as risky. There is plenty of evolutionary logic behind this idea, considering that humans spent much of their existence as both predator and prey. There is safety in numbers.

So as much as we know the value of thinking outside the box or being contrarian, and as much as we value and revere those in society who are capable of going it alone, our [lizard brains](#) take over when it comes down to financial decisions and we seek the safety of crowds. This is true for amateurs and professionals alike and is well documented in the rapidly growing popular and academic literature on behavioral finance.

GMO takes the idea of career risk and argues that it can drive periods of over- and undervaluation. As Ben Inker, the head of asset allocation at GMO was quoted as saying in a recent Advisor Perspectives [article](#):

“The market tends to be priced in a way that if you want to try to outperform, you have to take a risk of looking like an idiot,” Inker said. ... Markets exhibit herd-like behavior, which in turn encourages momentum and other self-reinforcing behaviors, such as money flowing into whatever strategy has been doing well, Inker said. That merely ratchets up valuations within better-performing asset classes and sectors, he said, creating a self-fulfilling prophecy.

Of course, this cannot continue indefinitely. Eventually, the risk-return trade-off becomes so one-sided that prices get pushed back toward fair value. Consider this chart from GMO.



The Way the Investment World Goes Around: They Were Managing Their Careers, Not Their Clients' Risk

Rob Arnott suggests that by embracing maverick risk and deviating from the traditional 60/40 stock bond portfolio, one can add several percentage points a year beyond the expected returns that are available from traditional asset classes. This is good to hear, as broad equity and bond market indexes are priced to deliver very low single-digit returns over the next 5-10 years, with a high likelihood of meaningful periods of negative returns. Consider my post, [Expensive Markets Mean Low or Negative Prospective Returns](#).

Arnott advocates approaches ranging from adding non-core asset classes such as emerging markets, high-yield bonds and alternative strategies to using his own fundamentally weighted indexes. Importantly, he advocates employing an active, dynamic and contrarian approach to asset allocation, which presumably does not require



investment in each of these asset classes or strategies at all times. It does however require that each of these asset classes and strategies are at least part of investors' universe of potential investments.

Table 2. From the Classic 60/40 to a Maverick Allocation

| Asset Class | 60/40 | Add TIPS, PE, HF, and RR | 50/50 Cap and RAFI | Add HY, EMB, and LDI | Add GTAA, AA, and RR | All-In Maverick |
|----------------------|-------|--------------------------|--------------------|----------------------|----------------------|-----------------|
| U.S. Stocks | 40.0 | 35.0 | 17.5 | 15.0 | 10.0 | 0.0 |
| RAFI [®] US | 0.0 | 0.0 | 17.5 | 15.0 | 15.0 | 10.0 |
| International Stocks | 15.0 | 15.0 | 7.5 | 7.5 | 5.0 | 0.0 |
| RAFI International | 0.0 | 0.0 | 7.5 | 7.5 | 7.5 | 10.0 |
| EM Equity | 5.0 | 5.0 | 2.5 | 5.0 | 5.0 | 0.0 |
| RAFI EM | 0.0 | 0.0 | 2.5 | 5.0 | 5.0 | 15.0 |
| Private Equity | 0.0 | 5.0 | 5.0 | 5.0 | 5.0 | 7.5 |
| GTAA, AA | 0.0 | 0.0 | 0.0 | 0.0 | 10.0 | 15.0 |
| U.S. Bonds | 40.0 | 25.0 | 12.5 | 5.0 | 2.5 | 0.0 |
| RAFI IGB | 0.0 | 0.0 | 12.5 | 5.0 | 5.0 | 0.0 |
| FI HY+EMB | 0.0 | 0.0 | 0.0 | 5.0 | 7.5 | 15.0 |
| LDI | 0.0 | 0.0 | 0.0 | 10.0 | 7.5 | 15.0 |
| Long TIPS | 0.0 | 10.0 | 10.0 | 10.0 | 7.5 | 5.0 |
| HF & RR | 0.0 | 5.0 | 5.0 | 5.0 | 7.5 | 7.5 |
| Geometric Return | 4.59 | 5.2 | 6.08 | 6.98 | 7.27 | 8.54 |
| Standard Deviation | 10.42 | 10.67 | 10.98 | 11.79 | 11.54 | 11.45 |

Source: Research Affiliates.

Research Affiliates' Expected Returns for Various Allocations

GMO's Inker agrees that *truly active* asset allocation drives investment returns:

“The good news is that in the investment business there are very few people who do real asset allocation and actually move money around in an aggressive way,” Inker said. “It’s a tough thing to do and survive. The nice thing about it, and the reason why we do it, is because this means it’s an inefficiency that is not going to get arbitrated away anytime soon.”

GMO know what they are talking about when they say it’s a tough thing to do *and* survive. Their refusal to chase expensive markets in the late 1990’s meant they lost half their assets under management. Half of their revenues dissipated because they refused to follow the herd during the dot-com bubble.

They were willing to embrace maverick or career risk and looked like idiots for doing so. That must have been a somewhat painful experience, but perhaps they were comforted by John Maynard Keynes:

It is the long-term investor ... who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is the essence of his behavior that he should be eccentric, unconventional and rash



in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.

Of course, the bubble burst, GMO made its clients lots of money while most others were comfortably failing (read: losing money) the conventional way and the assets came back and then some. In his piece, Arnott is quick to point that out.

Comfort is rarely rewarded. Investors can move down the path toward this maverick portfolio, careful not to exceed their board's or their client's "comfort" threshold. This approach goes against human nature and invites second-guessing whenever it inevitably doesn't work.

Arnott is leaving us too much of an out. GMO clearly *did* exceed its clients' comfort thresholds. That's why so many left.

If we spend too much time as professional investors calibrating ourselves to our clients' comfort thresholds, there is significant risk that we will make sacrifices to our process, our investment discipline and ultimately our fiduciary duty of acting in our clients' best interests. It's not just a little ironic that the line between doing what is right for our clients and doing (or not doing) things that might make them fire us is a blurry one indeed.

Client-manager alignment

How do we deal with this paradox?

For starters, there needs to be a high level of trust between clients and investment managers. This trust should be based on obvious considerations like ethics and integrity as well as on the more difficult ideal of alignment — understanding the investment objectives and the process by which we are trying to meet those objectives. This requires open communication and client education among other things.

Seth Klarman is unequivocal when he says, "Having great clients is the key to investment success." For those unfamiliar with Klarman, his Baupost Group hedge fund gained an average of 17 percent annually from 2000-2010, a period in which the S&P 500 Index fell 1 percent annually. Baupost faced some criticism during the 1990s when the fund had a hard time keeping up with the raging and speculative bull market, but the fund has returned 19 percent a year since it was started in 1982 (when Klarman was 25 years old), even as it held more than 40 percent of its assets in cash at times.

In an [interview](#), he described Baupost's ideal client as having two characteristics.



If we feel we have had a good year, they agree, regardless of relative performance. When we call, asking them to consider adding new capital, they appreciate the call and add new capital.

The second characteristic is important for Baupost because its managers often invest in illiquid securities or non-traded assets such as real estate. When prices are down, they want to have extra liquidity from clients to purchase more assets. Such was the case in 2008-2009, when Baupost [doubled its assets under management to \\$22 billion](#) after being closed to new investors for many years.

The subtext of Klarman's first point above is that his clients know that his number one priority is to generate positive absolute returns regardless of the market's direction. Klarman's key to investment success is having clients who want what he is offering: a strategy that seeks out attractive returns for the risk he is incurring without the expectation that he will outperform in every market environment. He is clear that the returns his fund will generate are a function of the opportunity set presented by the market's valuation, and he is not afraid to return capital to investors (whether they want it or not), [as he did at the end of 2010](#), if the market is not offering abundant opportunity.

At a recent [Grant's Interest Rate Observer](#) Conference, Klarman professed to "being surprised at how little cash we have." The Baupost portfolio held 28% in cash. While 28% is a large amount of cash (mutual funds currently hold 3.4% of their assets in cash) to most relative-return investors, the expensive valuations in the stock and bond markets have pushed an absolute return-oriented investor like Klarman away from the public markets. He has been buying hotel properties in places like Charlotte, N.C., at a 7-9% cap rate, while keeping 28% of dry powder for an eventual return to attractive valuations in the public markets.

Bringing it all home: What's *your* benchmark?

We should place less emphasis on the conventions of the day and seek to arrive at a fundamental understanding of what really drives investment returns so that we can make smart decisions about where we put our money. We cannot accomplish this, however, without knowing what our future liabilities or objectives are and addressing what Arnott calls "the asset/liability mismatch, which leads to a risk that we cannot cover our future obligations."

For most individuals, these future obligations exist as a desire to maintain a certain lifestyle in retirement, leave a legacy or give back to the world. These obligations tend to be absolute in nature – that is, requiring a certain level of assets – independent of how much one's neighbor is making on his portfolio or how much the market returned last year.



As [Tom Brakke of the Research Puzzle](#) put it:

Decisions large and small are off kilter because the looming shadow of benchmark risk overwhelms almost everything else. ... Many of the benchmarks are, in fact, false ones. I dare say that the S&P 500 is not a natural liability for many individuals or organizations to fund. Nor is some broader market portfolio. These are made-up constructs and should not be the prime guide for decision-making. But the business of investing is tied to them, to its detriment and that of its clients.

The bull market of the 1980s and 1990s provided the fuel for the relative return performance derby embraced by so many today. In a consistently rising market, when nearly all returns are positive, the collective focus shifts towards relative returns and places undue importance on false benchmarks such as meeting or exceeding the S&P 500. The last 10 years demonstrated the importance of remaining vigilant and keeping our eye on the true natural benchmark of earning absolute returns without being exposed to catastrophic or permanent losses of capital.

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