Asset Allocation in an Uncertain Economy

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by Robert Huebscher

Advisors should not bet on whether the recession will be L-, V-, or W-shaped. Instead, Ron Albahary said they should use strategic asset allocation and overweight or underweight those asset classes that have historically done well at certain points in the economic cycle. Albahary is the CIO of Convergent Wealth Advisors, a Washington, DC-based wealth manager. He spoke at the Schwab IMPACT conference on Thursday.

Albahary advocated assessing risk in each of four categories: deflation, slow growth and deleveraging, rising interest rates, and inflation. He discussed the reasons why investors should be concerned with each of those risks and the asset classes that would best defend against them:

- Deflation is the overriding theme in the economy now, and is evident from low industrial capacity utilization and decreasing labor costs. The traditional defense against deflation has been Treasury bonds, which did well in the 1930s. However, Albahary said other asset classes, such as growth and small-cap stocks did well in that decade, possibly because of the scarcity of growth opportunities in the economy at that time. In Japan's deflationary decade of the 1990s, blue chip stocks did exceptionally well. High-dividend stocks have also done well under deflation. Albahary said systemic shocks often occur during deflationary periods and investors should hedge against them.
- Slow growth and deleveraging are also pervasive, and can be seen in increased consumer saving and decreased consumer credit and spending. In the US, single-family homeowners have approximately $1 trillion in negative equity and Albahary said they would be "delevering for the next decade." He recommended diversifying against this risk by investing in emerging markets, which have much lower debt/GDP ratios. Consumers in those markets will be entering a phase of borrowing and consumption. Albahary said risk and merger arbitrage strategies were good hedges against slow growth and deleveraging, because companies will have a hard time growing organically and will grow through mergers and acquisitions instead.
- Rising interest rates have started to happen in the longest-dated Treasury securities, and Albahary said that we could be at the end of a 30-year cycle of decreasing interest rates. He said that multi-strategy hedge funds were good hedges against this risk, since they can help restructure the debt of levered companies. A lack of supply of AAA-rated securities may cause spreads to compress even if rates rise, he said, and that would favor variable-rate bank loans and high-yield bonds.
- Inflation, while not yet a threat, has historically moved in multi-decade cycles, and Albahary said we could be at the beginning of such a cycle. Emerging market debt, commodities, and master limited partnerships are good defenders against inflation. He also recommended global macro hedge funds because they can capitalize on the volatility that would likely accompany high inflation.

Once advisors have identified their preferred ways to defend against these four risks, they should overweight or underweight investments to reflect their assessment of the likelihood of possible scenarios. Albahary said mean-variance optimization could be used for this purpose, and he advocated extensive diversification.

If hedge funds are used, Albahary recommended hiring managers that are flexible and have a broad mandate across asset classes. He provided data, based on the long-short hedge fund managers his firm has used, which showed their ability to ride trends and reduce risk in times of stress.

Albahary also identified a number of lessons he has learned from his use of hedge funds:

- Volatility and correlation were more than models anticipated
- Leverage can be toxic
- Position and investor concentration are critical
- Liquidity of funds must match underlying holdings
- Operational due diligence a must

Portfolios should be stress tested, and Albahary does this by simulating five different environments: global market collapse, double-dip recession, moderate growth, continued expansion, and stagflation. He calculates returns and volatilities under each of those scenarios and shows those results to clients as part of his standard reporting. “I want to make sure clients know what they have signed up for,” he said.

He also creates a report card to grade himself on how well he has done defending against risk and how well his overweights and underweights performed. He keeps a diary of investment decisions in order to facilitate his grading process.

