

The Stag and his Reflection

I was sat with my godson at the weekend choosing a bed time story. To my surprise I was handed a copy of that well known and staunch guide to childhood morality – Aesop's Fables.

I picked one which I had not read before titled, "The Stag and his Reflection". The abridged version goes like this:

A stag bends down to drink from a stream, whilst doing so stops to admire his impressive antlers in the cool reflection. At the same time, he ashamedly notices how small his hind legs are in comparison to his large antlers. At that instant he sees a lion stalking him and takes off at full speed for the safety of the forest only to have his impressive antlers snag on the branches. Just before the Stag gets eaten, he muses on the irony of how his impressive antlers were the cause of his demise and if it were not for them his small but nimble hind legs would have carried him to safety.

I couldn't help drawing some parallels between the lessons in this story and portfolio management. Much like the stag, all too often it's the big, shiny, "risk-on" trades which we spend time justifying to our

investors as the reason why we earn our keep as active managers. The currency hedges and uncorrelated, risk-off investments which are still used in portfolios are merely a prerequisite of prudent investment diversification.

Put it this way, we have seen many a portfolio manager getting enthusiastic about Emerging Markets or High Yield Debt, yet none seen jumping up and down about their elevated cash positions or the returns opportunity coming from US Treasuries, Gold or Money Market funds. In reality, much like the hind legs of the stag, these investments are exactly the type of unexciting strategies that could protect portfolios when stock market volatility is watching and waiting in the long grass.

So why do we allude to this now? We put out a note about FAANG stocks and the broader US market dragging global equity markets into positive territory for 2018 and more importantly, what would happen to global equities if the US market and these five names were to correct. Well, October's volatility hit the US hard and clients with global portfolios turned negative as the US went into the red for the year.

What TAM concluded from October was not panic in the market, not the end of days which some were suggesting, but a meaningful sea change in the investing environment towards one of enhanced volatility and persistent uncertainty which we believe will keep a lid on investors getting into another 2017 style, year-long rally.

To put this in perspective, October's volatility saw more 1% daily moves up and down than the entirety of 2017 and our core message moving into 2019 is that this environment is not about to revert back to 2017. One could argue that the market environment has been so "risk-on" for the last decade that portfolios have put on huge long positions in risk assets with often little regard for volatility.

Now, this call has delivered handsomely for clients but if unchecked, much like our stag's antlers in the forest, these flashy, risk-on positions structured for a bull market could be the very thing that brings many an investment strategy to its knees.

Are portfolios and managers who have been investing in a ten-year bull market ready to begin shifting from QE fuelled growth, to one where volatility is more prevalent and gains harder to come by? Are they reluctant to get off the rising tide of a bull market too early for fear of missing out? Or is it best summed up in the words of Warren Buffet, "Nothing sedates rationality like large doses of effortless money"?

TAM has been, since Q2, pulling in its more exotic overseas investments and taking profits in preparation for this sea change towards volatility. Clients have enjoyed, with the help of compounding, very strong long-term returns from these investments and we are more than happy to accept that the bull is tiring.

Protecting capital may become more important in the next 12-18 months and for TAM, it's now about making adjustments to portfolios in periods of "risk-on", to shore up the defensive elements of portfolios.

Over the positive periods you will see us reduce risk exposure and add US and UK Government Debt, Gold, market neutral and low beta strategies because that will stand the best chance of protecting these gains in this new market dynamic.

To bring us back to the stag and his reflection, we too admire our antlers (long-term gains made) but know the value hidden in our hind legs (defensive attributes of portfolios), and it's time for us to learn from the fable. It may not be the lion that mauls you, but a bear.

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