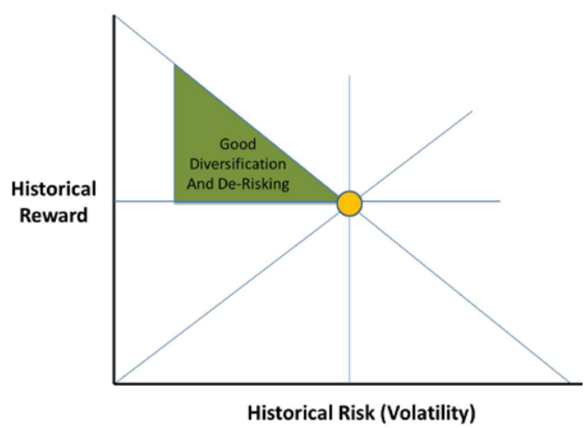
"It's Still Not About the Nail"

Reader reaction to the March 31 Epsilon Theory note, "It's Not About the Nail", was probably the strongest and most positive for any note to date. The message in a nutshell: financial advisors of all stripes and sizes would be well-served to do more than serve up old-school diversification platitudes in this Brave New World of a bull market that everyone hates, and the behavioral insights of regret minimization are an effective framework for making that adaptation.

This is a message that bears repeating, and thanks to *Institutional Investor* that's what's happening. A condensed version of "It's Not About the Nail" can be found on the Institutional Investor website, that piece will appear in the print magazine later this month in their "Unconventional Wisdom" column, and I've appended it below.

I think the reason this message strikes a chord is that it not only puts into words what a lot of people are feeling in an inchoate fashion, but also suggests a toolkit for improving the strained dialog between advisors and investors. It's possible to take our tried and tested (but tired) notions of portfolio construction and energize them with the tools of game theory and behavioral economics, so that we get to the *meaning* of words like "diversification" and "de-risking".

In the note I presented one way of thinking about all this in simple graphical terms, by taking the historical risk and reward of a portfolio or a subset of a portfolio and just *seeing* what the impact of a diversifying strategy would actually have been as seen in risk/reward space.



The goal here is to move the original portfolio (the gold ball) up and to the left into the green triangle that marries both the traditional meaning of diversification (maximization of reward per unit of risk) and the behavioral meaning of de-risking in a bull market (minimization of the risk of underperformance). There ARE strategies that accomplish this goal, but the trick is finding the strategies that do this for the actual portfolio you have today, not some hypothetical portfolio or index.

We've built a set of tools at Salient within our systematic strategies group to analyze the historical impact of a wide range of diversifying strategies from a wide range of asset managers on actual portfolios, and then to map the impact of various diversifying strategies in risk/reward space. It's not rocket science, and I'm sure any number of Epsilon Theory readers could develop a similar toolkit, but we've found it to be a very useful process for not only evaluating, but also *communicating* how diversifying strategies can make an existing portfolio better for an investor's needs. Sometimes Salient strategies show up well in this analysis; sometimes they don't. If you're familiar with the Progressive Car Insurance commercials with Flo, you get the idea.

If you're an investment professional and/or financial advisor with a portfolio you'd like to have analyzed in this manner, reply to this email or drop me a note at bhunt@salientpartners.com , and I'd be delighted to set it up for you.

As with all things Epsilon Theory-related, there's no fee or obligation associated with this analysis. Thanks again to my partners and colleagues here at Salient for their commitment to releasing useful intellectual property into the wild. I think it's a smart, non-myopic view of what it means to be an asset manager in the modern age, but a rare bird nonetheless.

All the best,
Ben

***Institutional Investor* – "Unconventional Wisdom", April 5, 2015**

Bull Session: How to Derisk in a Bull Market

There's a massive disconnect between advisors and investors today, and it's reflected in both declining investment activity as well as a general fatigue with the consultant-client conversation. Consultants continue to preach the faith of diversification, and their clients continue to genuflect in its general direction. But diversification as it's currently preached is perhaps the most oversold concept in financial advisor-dom, and the sermon isn't connecting. Fortunately, behavioral economics offers a fresh perspective on portfolio construction, one that lends itself to what we call Adaptive Investing.

Investors aren't asking for diversification, which isn't that surprising after six years of a bull market. Investors only ask for diversification after the fire, as a door-closing exercise when the horse has already left the burning barn. What's surprising is that investors are asking for de-risking, similar in some respects to diversification but different in crucial ways. What's also surprising is that investors are asking for de-risking rather than re-risking, which is what you'd typically expect at this stage of such a powerful bull market.

Why is this the most mistrusted bull market in recorded history? Because no one thinks it's real. Everyone believes that it's a by-product of outrageously extraordinary monetary policy actions rather than the by-product of fundamental economic growth and productivity — and what the Fed giveth, the Fed can taketh away.

This is a big problem for the Federal Reserve, as its efforts to force greater risk-taking in markets through large-scale asset purchases and quantitative easing have failed to take hold in investor hearts and minds. Yes, we're fully invested, but just because we have to be. To paraphrase the old saying about beauty, risk-taking is only skin deep for today's investor, but risk-aversion goes clear to the bone.

It's also the root of our current adviser-investor malaise. How so? Because de-risking a bull market is a very different animal than de-risking a bear market. As seen through the lens of behavioral economics, de-risking is based on regret minimization (not risk–reward maximization like diversification), and the simple fact is that regret minimization is driven by peer comparisons in a bull market. In a bear market your primary regret — the thing you must avoid at all costs — is ruin, and that provokes a very direct physical reaction. You can't sleep. And that's why de-risking Rule No. 1 in a bear market is so simple: Sell until you can sleep at night. Go to cash.

In a bull market, your primary regret is looking or feeling stupid, and that provokes a very conflicted, very psychological reaction. You want to de-risk because you don't understand this market, and you're scared of what will happen when the policy ground shifts. But you're equally scared of being tagged "a panicker" and missing "the greatest bull market of this or any other generation." And so you do nothing. You avoid making a decision, which means you also avoid the consultant-client conversation. Ultimately everyone — advisor and investor alike — looks to blame someone else for their own feelings of unease. No one's happy, even as the good times roll.

So what's to be done? Is it possible to both de-risk a portfolio and satisfy the regret minimization calculus of a bull market?

In fact, our old friend diversification is the answer, but not in its traditional presentation as a cure-all bromide. Diversification can certainly de-risk a portfolio by turning down the volatility, and it's well suited for a bull market because it can reduce volatility without reducing market exposure. The problem is that diversification can take a long time to prove itself, and that's rarely acceptable to investors who are seeking the immediate portfolio impact of de-risking, whether it's the bear market or bull market variety.

What we need are diversification strategies that can react quickly. That brings me back to adaptive investing, which has two relevant points for de-risking in a bull market.

First, your portfolio should include allocations to strategies that can go short. If you're de-risking a bull market, you need to make money when you're right, not just lose less money. Losing less money pays off over the long haul, but the path can be bumpy.

Second, your portfolio should include allocations to trend-following strategies, which keep you in assets that are working and get you out of those that aren't. The market is always right, and that's never been more true — or more difficult to remember — than now in the Golden Age of the Central Banker.

W. Ben Hunt, Ph.D.
Chief Risk Officer

SALIENT
4265 San Felipe, 8th Floor, Houston, TX 77027
Direct: 713.548.2627 | Fax: 713.993.4098
Twitter: @EpsilonTheory
bhunt@salientpartners.com

To subscribe to Epsilon Theory:

- Sign up here: www.salientpartners.com/epsilontheory/subscribe
- **OR** send an email bhunt@salientpartners.com with your name, email address, and company affiliation (optional).

There is no charge to subscribe to Epsilon Theory and your email address will not be shared with anyone.

Follow me on Twitter: @EpsilonTheory

To unsubscribe to Epsilon Theory:

- Send an email to bhunt@salientpartners.com with "unsubscribe" in the subject line.