Taking On More Risk Is Always Risky Business

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In today’s environment, a lot of investors just don’t know which direction—equities, commodities, real estate, or fixed income—to turn. To anyone looking beyond the current moment, the options are baffling. Unfortunately, many investors are using short cuts to manage their portfolios and thereby taking more risk than they may realize.

When it comes to the debt market, interest rates around the world remain at microscopic levels. The combination of the decades-long bull market in fixed income and the fear of being on the wrong side of rising rates has made investors understandably cautious. They know something’s going to happen, but it’s uncertain when or what that will be. As a result, there’s been a scramble to find alternative investments to fill the portfolio need for a low-risk income stream that fixed income securities have been unable to deliver.

The problem is that when investors look at alternatives, the vehicles they’re looking at are substitutes for the equity markets that come with similar, or even greater, risk. And for most investors, taking on more risk when what they really want is a fixed income-like yield with downside protection, that doesn’t make sense. In fact, it is nearly impossible to find when interest rates are rising.
Certainly, equities can be quite tempting these days as we’ve seen the markets climb to new levels. But just looking at the overall index numbers hides the fact that a lot of the upward momentum has been driven by just a few companies, such as the so-called FANG group (Facebook, Amazon, Netflix, Google) along with Microsoft.

Over the last few years, there’s also been a lot of cash pouring into low-cost index products and large cap ETFs. We’re seeing considerable amounts of capital flowing into these products because investors need to put their money to work but they don’t know where else to invest it. As such, they opt to save money on management fees under the false belief that the market is efficient so it doesn’t make sense to pay someone to select securities for you – rather, just buy a broad basket at a low cost and you should do fine. In fact, that trend – insatiable demand from low-cost ETF products – is one of the main factors driving the appreciation of these large companies.

The question that investors need to ask themselves now is just how much longer this trend can continue. I could be wrong, but it seems unlikely that the largest companies can
continue attracting new capital forever although that’s certainly where the flows have been going lately.

I may sound like a curmudgeon, but the current situation in the equity markets is beginning to resemble some troublesome situations we’ve seen in the not-to-distant past, like the internet and housing bubbles. In those cases, people heard about all the money other people were making and wanted to get in on the action. But nothing lasts forever and, in both instances, inflows went way past the point of sustainability and then everything blew up.

This point in the current market cycle might be the right time for investors to engage in some serious self-examination in terms of what they’re really trying to accomplish with their portfolios. No one knows what’s going to happen next, but many observers feel the markets are about due for a sudden change or an unpredictable correction. If that happens, there are bound to be opportunities for sharp-eyed active investment managers who have held some cash on the sidelines for just such an event.

Perhaps part of the reason for the unusual activity we’ve seen lately is because of the great changes we have witnessed in the capital markets over the last few years. The top companies in the
S&P 500 resemble the “nifty fifty” of some years back, when the conventional wisdom was that investors couldn’t go wrong if they put their money into IBM, Xerox, or one of the other few chosen ones. And that was true, until it wasn’t anymore since no company’s market valuation can grow to the moon.

These days, index and ETF investors are trying to pay low fees for something that takes a professional manager a lot of time and effort to accomplish. Worse still, they’re trying to replicate it themselves, but without having the time and ability to do proper due diligence on their investments. The situation is akin to lazy fixed income investors blindly purchasing “A-rated” structured securities (backed by packages of subprime real estate mortgages) under the false belief that the rating agencies’ imprimatur of a high rating would protect them in a real estate market crash. We know what happened when the music stopped in that situation. Risk is hard to calculate even for professional investment managers, but it’s a veritable minefield for the well-intentioned layperson. For the individual investor looking to preserve capital, which should be just about everyone, taking on ever-increasing levels of risk in the chase for greater yields and higher returns is probably not the way to go. It rarely works out well, as history has shown.
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