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The case for contrarian market timing in Wealth Management

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- Attempts to time the market often focus on lowering exposure to risky assets ahead of major crashes.
- This approach is inherently pro-cyclical and, if not purely driven by emotions, assumes some degree of return predictability.
- In practice, relying on risk reduction during times of financial distress can easily result in excessive risk-taking during calm periods and painful underperformance during recoveries.
- We, therefore, propose a contrarian approach that seeks to keep dry powder during normal times and systematically increase risks once markets experience extreme levels of stress.

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Profiting from the superior performance of risky assets in good times and selling when the music stops is the dream of many investors, but it carries a substantial risk of getting caught wrong-footed. While we are generally keen to emphasize the virtues of well-diversified, static allocations, this article introduces a dynamic approach that focuses on accelerating out of the crash instead of hitting the brake pedal in anticipation of it.

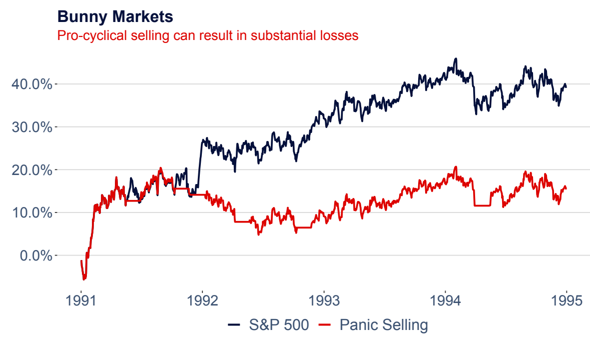

Figure 1: *Trying to get out when markets tank can exacerbate drawdowns.*

1 Dancing until the music stops

Even the most novice investor usually realizes pretty soon that the asset classes that promise a substantial, inflation-adjusted increase in wealth come with significant risks. Even a well-diversified portfolio of listed blue chips, the primary driver of risks and returns in standard wealth management products, will occasionally experience drawdowns of 20% to 50%. Not surprisingly, the prospect of losing that much, even if only temporarily, keeps many investors from simply allocating their investable assets to the equity market. Setting aside private markets for now, the most common solutions to this problem are cross-asset diversification or some kind of market timing.

Diversifying across asset classes with different risk-return profiles is the most common and straightforward way to manage a portfolio's downside risk. Even by law, Wealth Management clients nowadays must choose an investment profile based on their capacity and willingness to take risks. Based on this assessment, clients invest in solutions that strategically allocate a higher or lower percentage of the portfolio to more volatile assets such as equity or high-yield bonds. While this is regarded as a robust approach, it is naturally a compromise between an investor's desire to earn the highest return possible and his constraints imposed by a limited ability to stomach drawdowns. As compromises are typically sensible but seldom fully satisfying, generations of investors have been trying to essentially profit from the high returns generated by risky assets without suffering the losses associated with them by getting in and out of the market at the right time. The strategy's appeal is evident. An investor who sells the market before a severe crash and buys into it ideally close to the bottom doesn't just avoid a painful drawdown but enjoys significantly higher returns over the cycle.

Consequentially, a whole industry is occupied with forecasting economic recessions or the burst of (alleged) bubbles that may trigger a slump in the stock market. The dream is fueled further by the success stories of a happy few who indeed saw a crisis coming at some point and got rich, betting against the market or building a fantastic track record by staying on the sidelines in a pivotal year. Unfortunately, many investors also eventually experience that this game is incredibly complex. Risks are always looming somewhere in the real economy or the financial system, and markets frequently seem to be tanking just to bounce back sharply a little later.

For example, we find that over the past 100 years, the S&P 500 price index has experienced a more than 5% setback 67 times. However, only in 7 cases did the market ultimately lose more than 30%. In between all the mini-crisis, it is easy to get caught on the wrong side, and unfortunately, it can be very costly. In Figure 1, we compare the price returns of the S&P 500 with the comparable return generated by a hypothetical investor who panicked and sold his stocks once the market lost more than 5% between 1991 and 1994. We further assume that the investor, once burnt, stayed out of the market for a month before being overwhelmed by fear of missing out (FOMO) again.

2 The conceptual problems of pro-cyclical market timing

As can be seen, in this case, the result is not only a substantially lower performance but also an increased maximum drawdown - the strategy that is supposed to reduce risk indirectly exacerbated it. Obviously, there are other examples where such an approach would have worked better, and there is a reason why countless market participants invest considerable resources in similar timing attempts. However, we see several general problems inherent in a market timing or risk management strategy that essentially views the market as a game of musical chairs.

- Reducing exposure to risky assets during a time of distress is, by definition, pro-cyclical. Investors who engage in such a strategy can only gain an advantage if they are faster than their many peers trying to accomplish the same.
- An investor following this strategy implicitly assumes to have some knowledge of future asset returns. Reducing risk during times of distress only makes sense if a crisis is expected to arise soon or a crisis that has already begun is expected to worsen. While there is an extensive body of literature about positive autocorrelation and volatility clustering in equity markets, there is little empirical evidence that short-term returns are predictable.
- As everybody tends to rush to the exit door at the same time, investors who engage in such a pro-cyclical strategy may, in fact, not be able to execute it efficiently due to liquidity constraints and may be forced to accept elevated bid-ask spreads and prices below fair value.

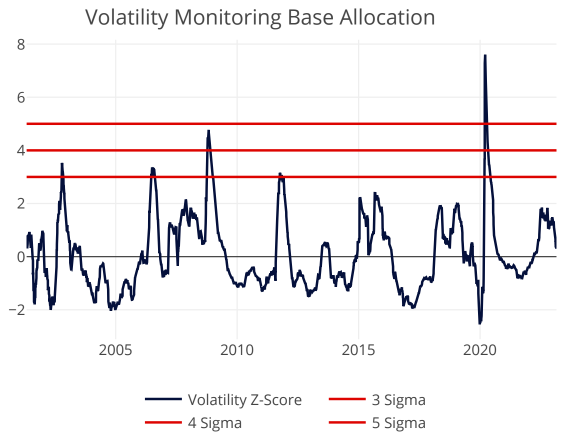

Figure 2: *Our proprietary volatility monitoring model measures the deviation of realized return volatility from long-term averages and is equally applied to single asset classes and our Multi-Asset solutions. We find that a surge to more than three standard deviations (3-Sigma Event) indicates a level of distress that justifies a first contrarian call. Most importantly, this approach generates only very few contrarian signals, keeping overall trading activity low.*

- The attempt to get out of risky assets at the right point in time itself is likely to induce a certain nervousness into the investment process, translating into elevated trading activity. In the worst case, an investor allocates a higher percentage of his wealth to risky assets than he can afford (either financially or psychologically), relying on his or his manager's ability to reduce risk on time. Sudden strategy overhauls and panic selling at exactly the wrong time are the dire consequences of such behavior.

3 Focusing on the gas pedal instead of the brakes

Readers of our publications will know that we tend to be critical of market timing in long-term-oriented investment management - well-defined short-term trading strategies are a different story. We, therefore, continue to advocate for managing portfolios with a steady hand and limited adjustments based on concurrent events. However, we believe there is value in approaching the timing question from a different angle.

Instead of pro-cyclically trying to pull the handbrake when a crisis looms, why don't we put more emphasis on the question of how to best get out of it?

Put differently, instead of holding risky assets during 'normal' times and switching to a **more defensive** allocation when they fear markets will (continue) to decline, investors can define one allocation they stick to in principle (base allocation) and a **more aggressive** portfolio (adjusted allocation) they switch to when markets

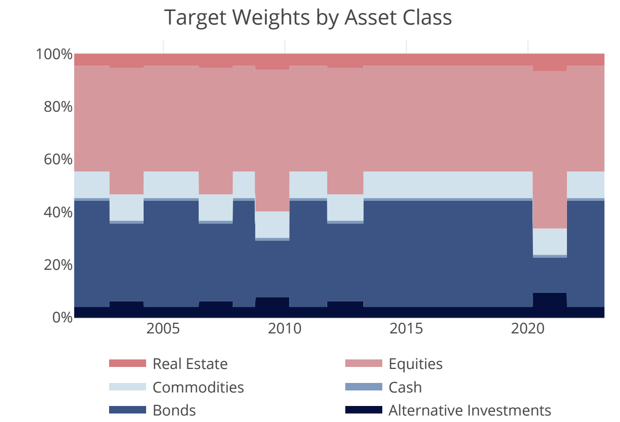

Figure 3: *The simulation displayed above assumes a CHF investor who generally holds a balanced portfolio with an equity exposure of 40% but is comfortable investing up to 60% in stocks when market stress reaches extreme levels.*

are obviously in a crisis. As it stands, this approach will not generate the kind of drawdown-free equity returns many market participants dream of. Yet, focusing on accelerating instead of breaking at the right point in time comes with several conceptual advantages.

- While it is difficult, if not impossible, to tell in advance whether markets **will** crash or continue to fall in the future, it is fairly easy to tell whether they **are** in a crisis at a certain point in time.
- Once markets are in turmoil and risk premia are clearly higher than normal (heightened credit spreads, depressed valuation multiples), there may still be some more pain ahead before the bottom is reached, but even if they accelerate a bit too early, contrarian investors are likely to benefit from liquidity discounts and temporary dislocations.
- We know from behavioural finance research that investors are loss averse and tend to become risk affine once under water. A contrarian approach to market timing that actively increases risks when markets are difficult caters to these psychological biases, indirectly benefiting from the desire to make up for past losses.

4 Discipline and good preparation are key

To "buy when others are fearful" is advice that intuitively resonates with many investors, but once a market slump starts to unfold, it is equally simple to find plenty of reasons why precisely this time is different and won't be followed by a recovery. Accordingly, we stress that the contrarian approach presented here requires careful preparation.

- First of all, in order to have sufficient dry powder when markets tumble, investors should opt for a base allocation that takes less risk than they can afford. Once times get tough, they must be comfortable switching to a higher gear.
- Secondly, given that the really painful crashes that occasionally happen can last a while, adjustments to the asset allocation should be made stepwise. Once markets start to tumble, we propose to keep some dry powder for the worst-case scenario (Great Depression, Great Financial Crisis, Oil Crisis). Again, the impact on returns may be small, but the increased comfort level is likely to be worth it.
- Crisis signals should be pre-defined and readily observable. Increasing the weight of risky assets during a crash requires discipline at a time when we are likely to suffer from intense emotions. Instead of continuously debating the macroeconomic outlook, we suggest that investors stick to objective and timely key risk indicators such as equity market volatility or credit spreads. Figure 2 provides an example where we apply our proprietary volatility monitoring model to a balanced multi-asset portfolio to detect abnormal spikes in uncertainty, indicating an elevated level of fear in the market.
- Contrarian investors need a long breath. The approach proposed here explicitly rests on the assumption that markets will generate positive returns in the long run, not that these returns are predictable in the short to medium term. Moreover, even once all crisis indicators signal that circumstances are dire, the situation may get worse before there the light at the end of the tunnel becomes visible. Therefore, we suggest that investors should be comfortable holding their riskier adjusted allocation for an extended period.

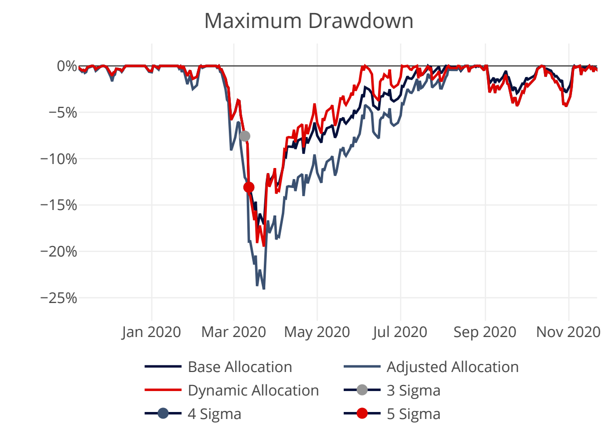

Figure 4: *During the Great Financial Crisis of 2008/2009, an extreme level of distress was detected well before markets eventually hit their lowest level. Nevertheless, a contrarian investor who stocks up on risky assets even a bit too early would not have experienced a substantially worse maximum drawdown and gotten out of the crisis significantly faster than an investor holding a static allocation.*

We have conducted some historical simulations and hereby showcase how such a strategy could play out based on our proprietary volatility monitoring model. In this case, we assume an investor with a balanced risk profile who allocates 40% to equities during calm market periods but is comfortable increasing the share of stocks to up to 60% in three steps when markets are seriously depressed. The latter is indicated by a surge in realized portfolio volatility by at least three standard deviations (see Figure 2).

This riskier allocation is then held for up to a year or once markets have made a strong recovery. Interestingly, over the period studied, the strategy would have generated the same return as the riskier portfolio (60% equities) but with maximum drawdowns closer to those experienced by the base allocation (40% equities).

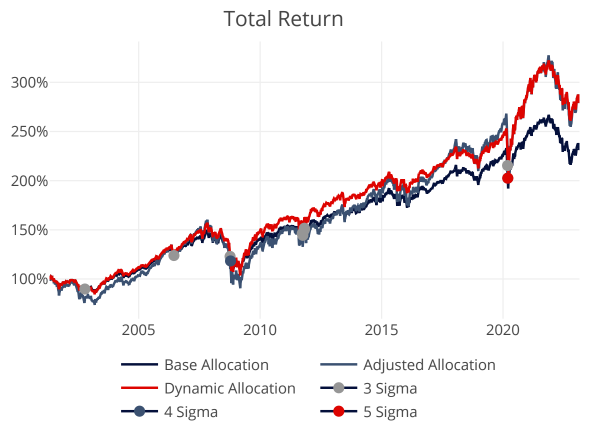

Figure 5: *Systematically increasing exposure to risky assets in the midst of a crisis will not prevent drawdowns in the first place, but we are confident that it can shorten the recovery period and generate higher risk-adjusted returns than a static allocation in the long run.*

Consequently, in our example, we measure improved Sharpe and Calmar ratios compared to both static portfolios. Again, investors should not expect miracles, but we believe that systematically keeping some dry powder and using it based on a well-structured process has the potential to improve long-term risk-adjusted returns without playing Vabanque.

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