# SSgA CAPITAL INSIGHTS

VIEWPOINTS

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## The Optimistic Unknown

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*"Know what you own and why you own it"—*
*Legendary Investor Peter Lynch*

**When Peter Lynch said these words, he was specifically referring to investing in stocks, but they are even truer today for fixed-income investments. Consider the US, where the Fed has pushed down interest rates to record lows and all types of less understood but higher-yielding vehicles have been the beneficiary.**

This is one of the legacies of today's Central Bankers. They may not have created goods or wage inflation yet, but their actions certainly have created asset inflation. The Central Banks have distorted the risk-free rate to such a degree that some investors have embraced what we call "the optimistic unknown". That is, they've been lured into higher-yielding instruments today, even though they don't fully "know" the underlying construction or potential risks, on the *hope* those investments don't falter tomorrow. This sort of behavior has a number of ramifications, including:

1. The marketplace will create more products to meet the demand.
2. As the most likely buyers are less familiar with these types of investments, they are, therefore, less sure of themselves and potentially may flee at the first sign of danger.
3. The lack of understanding will end badly in some cases and as with all communication snafus, the seller of the product will be blamed.

Chasing the "optimistic unknown" is behavior that of course, transcends investments and can be seen in many walks of life.

- Politics: voters often vote for an alluring new face whose beliefs, ethics and effectiveness are largely unknown rather than a candidate who is well known but disliked.
- Medical care: there is the well documented fact that men do not receive medical checkups at anywhere near the rate women do. In fact: "Not only do men tend not to see doctors, but a quarter of the men in the survey said they would wait "as long as possible" before seeking help for a health problem."* It is likely that many men choose some combination of fear and excessive optimism that they are healthy, vs. the risk of "knowing" for certain that they are not.
- Home ownership: the recent mortgage crisis is yet another example. Not only did investors seek the allure of slightly higher subprime rates on risks they certainly didn't foresee but speculative homeowners also took out aggressive mortgages on *hopes* for rising house prices or better incomes, neither of which happened for many.
- Hedge funds: it's an industry cloaked in secrecy where not disclosing a strategy is a sign of success. This likely means not all hedge fund investors fully "know" how their funds are managed but are tempted to try them nonetheless.

When surveying today's investor landscape, it is clear that what investors "know" is that Cash and CD's are at zero, Bonds are not far beyond until far out on the yield curve, and everything safe is under the rate of inflation, therefore offering a negative real return. It is also likely they "know" that these investments are less risky, at least in nominal terms, as they are backed by the taxing power of the Federal Government and/ or insured deposits of banks, which are ultimately also backed by the Government.

**Figure 1: Asset Growth—Bank Loans and Emerging Markets Debt**

Total Net Assets

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| Bank Loan | $13,868,516,757 | $24,202,316,502 | $43,331,418,268 | $57,204,309,197 | $72,826,671,140 | $113,668,896,410 |
| Emerging Markets Bond | $10,882,192,741 | $17,093,435,994 | $33,354,461,810 | $45,916,916,269 | $77,117,495,063 | $75,460,761,355 |

Source: Morningstar

Investors also know that a number of other vehicles do offer higher yields, at least on the surface. What is likely not known is the structure or true risk of these vehicles. Consider the asset growth in the following higher-yielding investments, as shown in Figure 1.

MLP's: in less than three years, the largest Master Limited Partnership ETF in the industry has grown from $600 million to over *$6 billion* in 2013.

Bank loans: mutual fund assets have grown from $14 billion in 2008 to *$114 billion* in 2013.

Emerging Market debt: mutual fund assets have grown from $11 billion to *$75 billion* since 2008.

These are just a few examples, but there are many more including the growth of "business development companies" and the growth of "credit" hedge fund strategies, both of which tend to offer attractive yields.

It's important to note that none of these fixed-income alternatives are necessarily problematic as investments on their own, when used in the right way and properly understood. But is it likely that all the investors who have moved into these vehicles know and understand them as well as they know what a CD, Money Market fund or Treasury Bond is?

Having hopefully made our point, what should we do about it?

1. Attempt to ask the tough questions and better understand the true risks and strategy dynamics of the investment, with a focus on learning the true downside in terms of how much principal is at risk. Factor those potential losses into your mental matrix of the overall portfolio design vs. fixating on the stated yield. For example, if the following high-level facts are foreign to you, you may want to do more research (answers at the end):
   a. What is the largest country in the Barclays Emerging Market Local Currency Diversified Index?
   b. What do REITS and Business Development Companies have in common?
   c. What sector is typically the biggest issuer of preferred stock?
2. Attempt to diversify by knowledge: the old standby comes in again but not just in terms of the equity/bond split and reducing total portfolio volatility. Consider a portfolio in terms of known risks and unknown risk. Then limit exposures to unknowns: consider capping at a certain percentage any individual asset class which you are less able to assess, and/or in the aggregate limit their total weight to be no greater than X % of a portfolio. Instructive in this mental exercise is the "Kelly Criterion" which implies that investors (and gamblers, as the Kelly Criterion was originally associated with blackjack strategy) should size a position by calculating their "edge" divided by the "odds". That is the payoff received if you are right, ergo the Kelly Criterion is: edge/odds. Investors in today's yield starved environment who pursue unfamiliar strategies would do well to consider the same type of equation except replacing edge with "knowledge". If you don't feel you know an asset class fully, then the numerator in the knowledge/odds calculation is zero, and your holding in that asset class would be zero as well. A better strategy given such an outcome would be to outsource the decision to buy that asset class to a professional who is experienced in the area.

Hopefully, by utilizing these tactics, investors will be better prepared to deal with the seductive powers of the "optimistic unknown" vs. the often less appealing but better understood outlook of what is known.

**Answers:**

**A. South Korea**

**B. They both must distribute 90% of their income**

**C. Financials**

* Louis Harris and Associates conducted a survey of 4,350 men and women and found that three times more men than women had not seen a doctor in the previous year, and one in three had no regular doctor. Only one in five women has no regular doctor. Read more: http://askmen.com/sports/health/29_mens_health.html#ixzz2VFYeQwUH

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