

## Talking Point

# Diversification, where art thou?

**Cross-market correlation is discussed by Anu Munshi, a partner at B&B Structured Finance**

There was a time, not so long ago, when it was relatively easy to observe patterns in markets and to diversify one's investments away from those patterns. Today, not only has the negative correlation between equity and fixed income broken down, but in certain periods, it has inverted to positive correlation.

Consequently, in the search for yield and diversification, investors move to more esoteric asset classes such as emerging markets, real estate, private equity and hedge funds. The movement of money into these hitherto illiquid areas of investment attracts fund managers to set up funds in these asset classes. Not only does this boost their liquidity, but it reduces their returns over time, as more money drives more funds to chase the same opportunities. All of which perpetuates the first-mover advantage.

As alternative asset classes become more liquid, permitting greater inflows and outflows of capital, we need to drill deeper to see if they truly diversify the investor from traditional asset classes. Real estate is cyclical since it is dependent on interest rates. Lower interest rates encourage home buyers to take out mortgages on new or existing homes, which drives up real estate prices. Emerging markets are cyclical, because they are subject to sovereign risk which is dependent on the macroeconomic environment.

Private equity, which is today financed primarily through LBOs, is dependent on low interest rates to minimise the cost of borrowing, and is therefore also cyclical. Hedge funds shouldn't be cyclical, given they target absolute returns and should therefore be uncorrelated to equities and fixed income.

But with increasing capital inflows into hedge funds and subsequently new entrants to the market, it is becoming increasingly difficult for hedge funds to find arbitrage opportunities. Many hedge funds today make their returns by taking outright directional risk. Add to the mix the fact that many hedge funds are active in leveraged structured credit products, and you end up with a return profile that could be as cyclical as a long-only fund manager.

The recent fallout in the US sub-prime mortgage market has only heightened the contagion effect across asset classes. Consider the following chain of events... A few sub-prime mortgage lenders in the US filed for bankruptcy, which caused the ABS securities backed by such sub-prime mortgages to fall in value. Hedge funds that had bought CDOs that referenced these ABS securities consequently suffered losses, particularly because they had bought such securities on margin (Bear Stearns AM's two funds being the most high profile example).

As margin calls kicked in, initial efforts to liquidate the CDOs in hedge fund portfolios caused their prices to gap lower and acted as a stern reminder of the downgrade and liquidity risk to CDO investors, who in turn have started to back away from the product or demand higher returns. This means they have also backed away from, or demanded higher pricing on, CDOs backed by leveraged loan portfolios.

As the CDO bid for leveraged loans has abated, some of the more aggressively priced or structured private equity-driven loan financings have been stalled. And banks that were involved in arranging these deals have now found themselves having to hold millions of dollars worth of high yield loans on their balance sheets.

This cycle covers real estate, structured credit, hedge funds, leveraged loans and investment-grade financials in the space of only six months, and illustrates only too painfully the fact that we are now in a low interest rate-driven playground full of bubbles and dominos. Prick one at your peril.

While it's easy and convenient to blame hedge funds and investment banks for many of the ills we see today, it's important for investors to think about how they can better equip themselves to perform in today's increasingly interconnected markets. They can do this primarily by keeping themselves informed of market trends and developments and by truly diversifying their investments.

On market developments, consider how CDOs have affected the pricing of a variety of asset classes, from triple-A rated ABS to investment grade corporate bonds to high yield leveraged loans. As a long-only corporate bond fund manager, understanding the CDO market would equip you to understand the forces that drive the pricing on the bonds you deal with in your fund, even if you can't or won't ever buy a CDO. An understanding of the mechanics and structure of leveraged loans would help an equity analyst better understand the ultimate structure of the company that he/she is evaluating.

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On diversification, the big question is where can one turn to for diversification? To answer that question, we need to ask another simple question: why do investors diversify? Diversification is driven by the need to reduce exposure to directional risks and to therefore smooth returns. But given diversification was traditionally carried out by investing in illiquid but higher-paying asset classes, greed for higher returns entered the equation somewhere along the way.

If a hedge fund pays 1% more than bank deposits, but does so whether the markets go up or down, it is a sound diversification investment. But a hedge fund that pays 5% more than bank deposits is far more attractive. True, but this additional return comes with some additional risk, be that directional risk or leverage. The aggressive fund may provide 5% over deposits for a few years, and indeed some hedge funds do that and better, but most of the time markets will catch up with the fund.

This is not to say that greed is bad. The message is be clear about what you're after, and invest accordingly. You are unlikely to find an investment that pays you better and has less risk and volatility than the comparables. But if you find it, hold on to it. And more importantly, remember that the next thing that comes along that looks and smells like it is unlikely to be the real thing.

If investors are indeed motivated by reducing exposure to directional risks, they need to spread their investments over regions, sectors, maturities and asset classes. This sounds complicated and it is. And it's why fund managers get paid management and incentive fees.

For investors with limited resources, one of the potential areas of diversification is hedge funds. But these are hedge funds that don't necessarily have the highest returns. What they provide is stable cash flows irrespective of the market. The skill then lies in identifying such hedge funds.

The repeated mention of derivatives, hedge funds and leverage in the context of today's troubled markets gets many thinking that they form the financial axis of evil. But the truth is that they provide many benefits to a wide variety of market participants and, in fact, aid diversification - derivatives allow investors to mitigate risk, hedge funds can be a good diversification investment and leverage allows hedge funds to generate good returns while taking minimal directional risks.

However, investors need to realise that they come with risks. And while it's easy to forget those risks in benign markets, the recent volatility across markets acts as a good reminder of those risks. All roads eventually lead to the phrase that is now more relevant than ever: caveat emptor.

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