Crisis Trading

To anyone who has cut their trading teeth since, say, October 1997, the title "Crisis Trading" might look like a redundancy. It is akin to an observation made long ago and in a different context by the author, that despite our self-image, war appears to be the natural state of human affairs and peace a temporary aberration we have to work very hard at to achieve.

A corollary here might be, "A little volatility is good; too much volatility is bad." One of the attributes of any market crisis is a high and rising level of volatility across almost all markets as panicked traders abandon risky positions in favor of perceived safety and buy insurance against those risks they choose to retain. Sometimes this effect spills over into a second-order phenomenon; the rise of volatility trading often compounds the stress in underlying markets (see "The VIX and Market Capitulations," May 2009).

But the principal characteristic of a financial crisis is the way in which the correlation of returns converges across asset classes to unitary levels, either -1 or 1, as the dominant trading impulse ceases to be asset allocation or diversification and turns into, "Get me out!"

The tragedy here is modern risk management is based on a set of unsubstantiated beliefs, half-baked speculations and fantasies about human behavior that should embarrass any shamans or Druid priestesses walking amongst us. The chief tool of this crowd, value-at-risk or VaR, is nothing more than a gigantic assumption the future will look much like the past, especially when the surrounding environment in the future deviates significantly from initial non-crisis conditions. This is akin to saying a lifeboat is perfectly functional so long as you do not launch it into the water during a shipwreck.

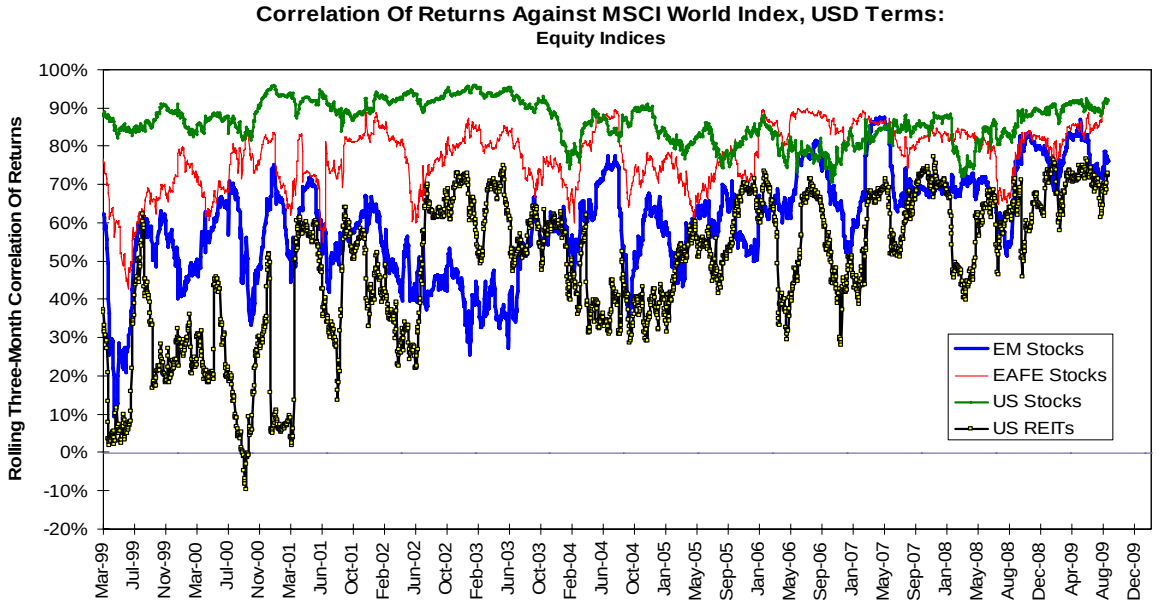
To those seeking career advice: Find something designed to fail at the very moment it is needed most, hire some thick-accented and socially dysfunctional math PhDs, have them run Monte Carlo simulations from now until the end of time and proceed to charge hundreds of thousands of dollars for your dubious service to mankind. The whole scam is nothing but an update of the memorable moment in *Trading Places* where Eddie Murphy gets the commodity brokerage business explained to him: "The good part is that no matter whether our clients make money or lose money, Duke & Duke get the commissions."

The simple fact is all of modern portfolio theory is based on the principle of diversification. If you encounter a period such as the financial crisis beginning in July 2007 and extending into March 2009, the end result of diversification is losing money in a large number of different places simultaneously. We suppose there is something of value in this, but whatever it is escapes us at the moment.

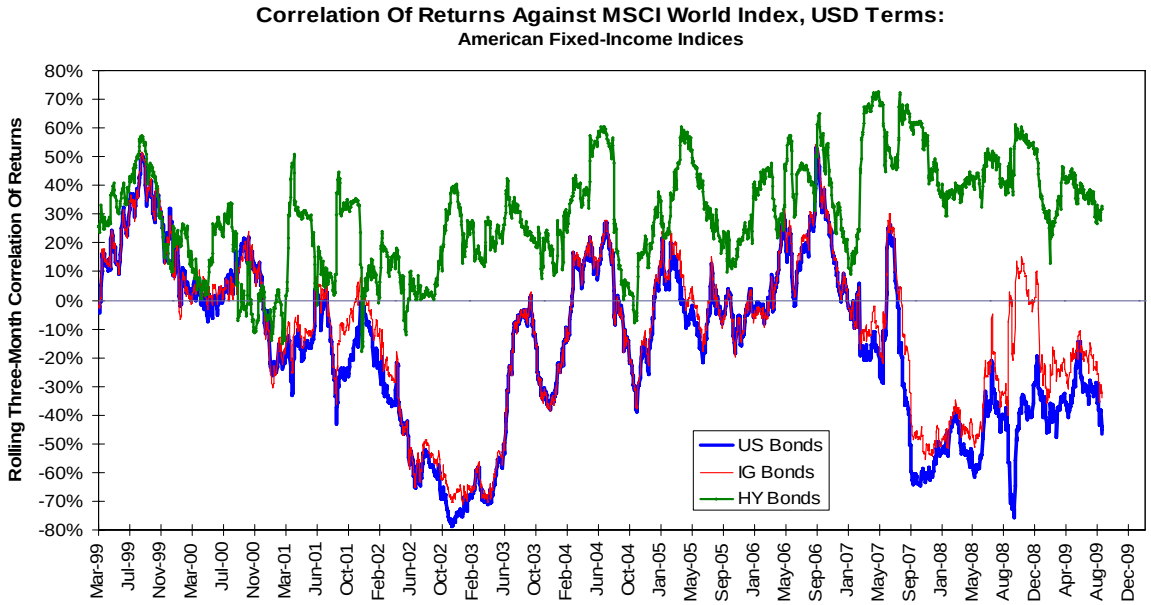
Asset Return Differentiation

If the above is at all true, then a differentiation of asset returns should signal the end of a financial market crisis. Let's use a set of total returns in U.S. dollar terms for a group of markets and construct a set of three-month rolling correlations of returns against the Morgan Stanley Capital International index. One exception will be made on the data, and that is the Journal of Commerce-Economic Cycle Research Institute's industrial materials index is not tradable and therefore does not have a total return associated with it.

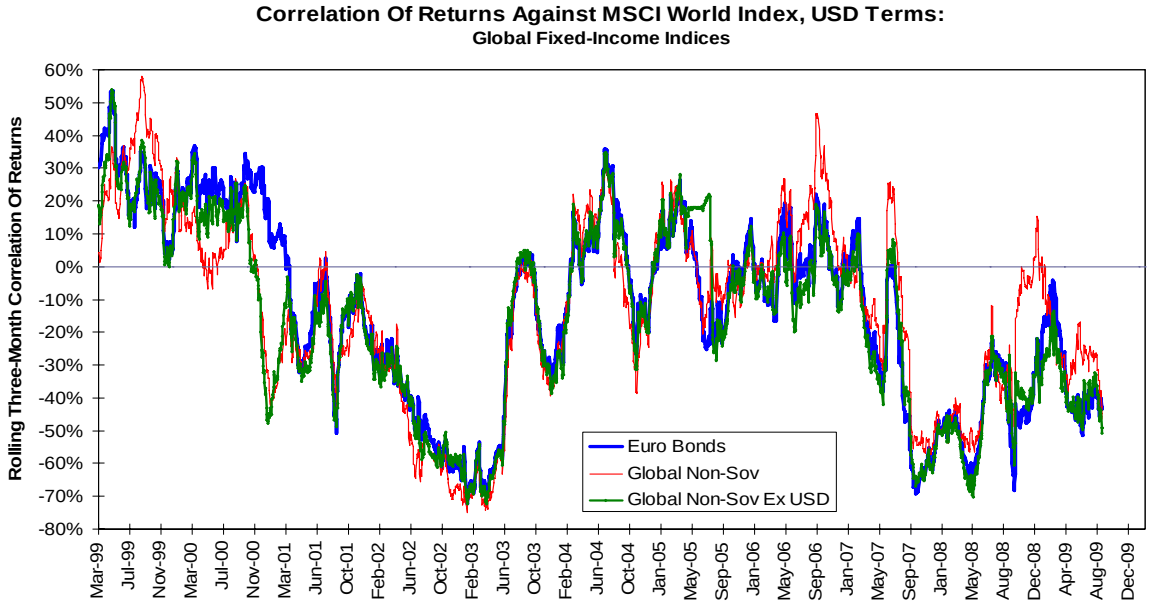
Four equity market indices are included in the comparison, the MSCI Emerging Markets Free (EM) index, the MSCI Europe, Australasia and Far East (EAFE) index, the MSCI U.S. index and the Dow Jones U.S. real estate index. As the U.S. stock market is the largest component of the MSCI World index, we should expect its returns to be correlated closely thereto over the life of the sample, and they are. The EAFE exhibits highly variable correlation and is at times more closely correlated to the World index than is the U.S. market. The EM has trended upwards in its correlation over time; this gives promise at long last to the supposition emerging markets will emerge one day. U.S. real estate is the least correlated amongst the equity markets. By April 2009, there was little evidence correlation of asset returns in the equity group was falling. Restated, global equity investing provides far less diversification than expected.



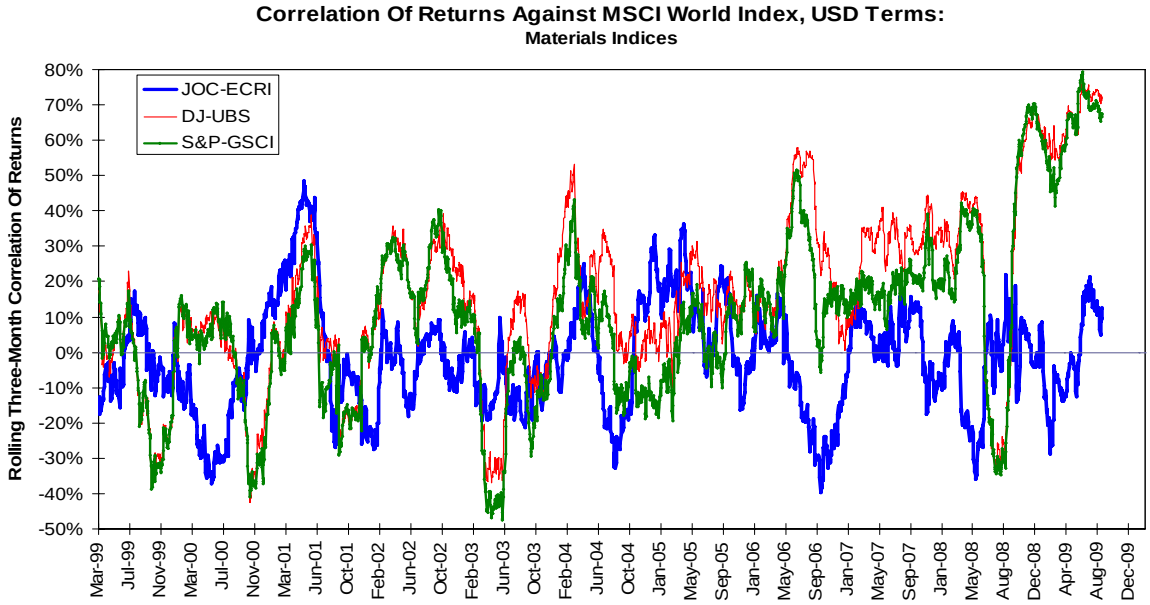
We can take two views of fixed-income markets versus the MSCI World equity index. The first is a comparison of U.S. government bonds, which include agency securities as well as Treasuries, and both high-yield and investment-grade corporates. Prior to the onset of the financial crisis in July 2007, investment-grade corporates performed much like government bonds; both tended to be correlated negatively to global equities and therefore provided a measure of diversification. By August 2008, however, investment-grade corporates diverged significantly from governments, and by October 2008 were correlated positively with global equities. High-yield corporate bonds, always understood to be more equity-like in their return characteristics, remained positively correlated to global equities over most of the data sample and therefore provided less diversification.



A set of global bond indices exhibited much the same pattern as did the American government and investment-grade indices. European bonds and global non-USD non-sovereign bonds virtually mirrored the non high-yield American indices. A broad global index of non-sovereign bonds inclusive of USD issues was distorted toward more equity-like performance during the short-term financial hiccup of 2006 and for most of the post-July 2007 financial crisis. The U.S. high-yield sector was large enough to affect the global index and reduce its value as a diversifying asset.



Finally, let's turn to two tradable commodity indices, the S&P-Goldman Sachs and the Dow Jones-UBS along with the non-tradable JOC-ECRI index mentioned above. The proponents of commodity investing used to proclaim its value as a diversifying asset, and for most of the sample period this claim held true. However, each and every time the world hit a financial crisis, the correlation of returns between the commodity indices and global equities turned positive. As a diversifying asset, they mimicked VaR and failed when needed most.



The Judo Trade

This irrational behavior, the convergence of asset returns during a crisis, is predictable. Nowhere is this mentioned in the conventional academic literature on portfolio management and asset allocation, all of which assumes rational financial decision-making. This is why quantitative traders, the black-box crowd that populates market-neutral and long-short hedge funds, tend to do very badly during periods such as August 2007 or April 2009 when the ragged assets they have shorted rise and the quality assets they have bought fall.

Take advantage of the stupid actions of smart people. Wait in the weeds for the next market regurgitation and buy low-quality stocks, sell highflying commodities and sell high-yield bonds. By doing everything you are not supposed to do, you will eviscerate the quantitative traders who never can bring themselves to believe either they or their models ever could be wrong.