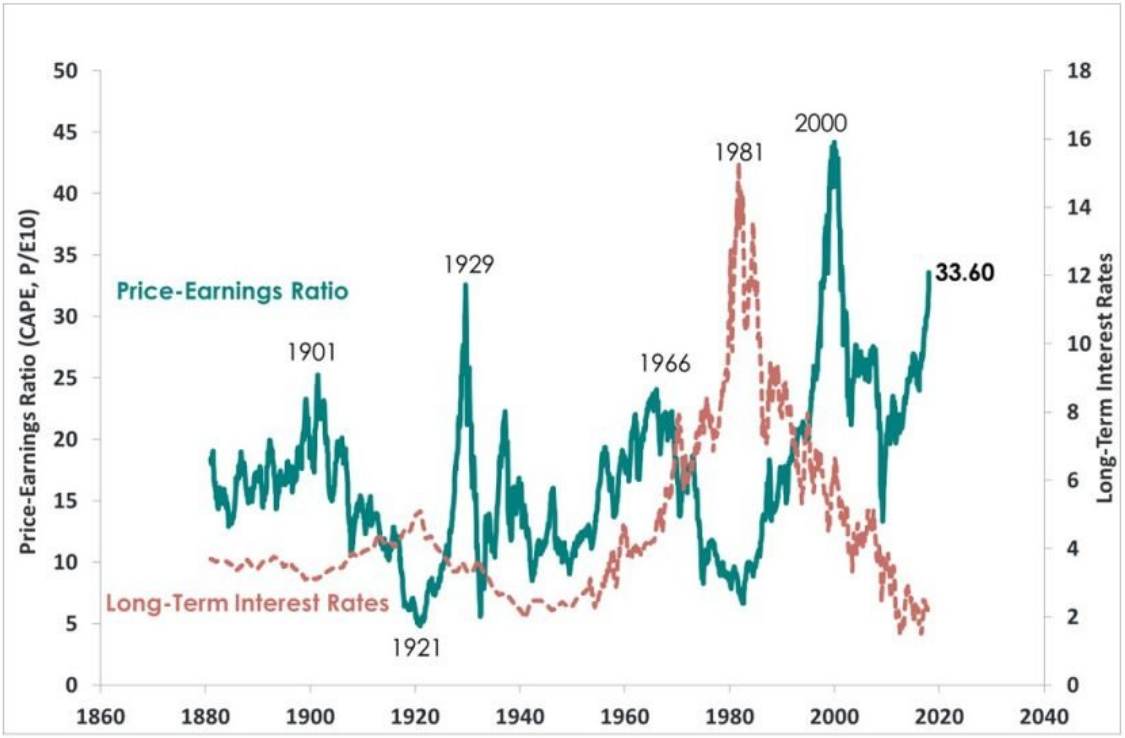
Insights, Tacit Thought | Weekly Investment Insights

The Risks of Overpaying

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We have written many times about the ‘comfort blanket’ that diversification provides investors by lulling them into a sense of false security. Holding more assets in itself does not necessarily reduce risk. The plethora of asset classes that can be used to diversify an investor’s portfolio range from government bonds, corporate debt and commodities to name a few. There is no doubt that, if bought at the right valuation, these assets provide significant diversification benefits to investors. There is also however significant risk to using these assets as diversifiers at times such as now.

Credit spreads (the premium an investor requires to take on the credit risk of a company) are relatively tight based on long term averages, whilst commodities have begun to show significantly higher correlations to equities over the past five years than they exhibited a decade ago. This latter point is no real surprise as commodities are seen as a global growth play by most Western investors. So, what about government bonds? These are relatively expensive in the context of history (as the red line on the chart below illustrates) with long term yields remaining firmly anchored below 2%.



Source: Robert Shiller

At this juncture, many of our peers would begin to extol the virtues of equities with solid cash flows and globally diversified businesses. At Tacit, our largest theme allocation has been ‘Value Alpha’ over the past seven years for exactly these reasons and so we actually agree with this thesis over the longer term. However, short term risk is something we focus on most when equity markets have been buoyant and two factors have combined to make us cautious in the short term.

First and foremost, equity valuations are no longer cheap when their earnings are compared to their current market price. Companies have good and bad years, which temporarily elevate or depress their earnings and so skew their price to earnings (P/E) ratios. For this reason, we prefer to use a measure that compares current prices with average earnings across multiple years (adjusting for inflation) to derive a cyclically-adjusted P/E ratio (CAPE). By comparing a company's current multiple-year P/E ratio to its historical average, you can then try to decide whether shares are cheap without being misled by short-term blips in profits. The green line in the chart above shows that the CAPE for the US market is currently trading at the upper end of historic ranges.

Our clients will know that at Tacit, we classify assets into two distinct pots; 'growth assets' and 'stabilisers'. The 'growth assets' are included in strategies to drive return whilst the 'stabilisers' are included to mitigate risk. Within our 'stabiliser' allocations we have not shied away from using cash as a separate asset class that dampens portfolio volatility whilst providing liquidity to invest into equities after an unforeseen event has occurred. Our approach has and will continue to be one of capital allocation rather than benchmark hugging. We will look to redeploy cash into risk assets as we see opportunities arise; however, patience will be key over the coming months as no investor can forecast what event will lead to an increase in risk.

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