



Back to Basics: Six Questions to Consider Before Investing

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In 2000, we were apt to hear quotes like the following from institutional investors:

“Our pension fund is a profit center.”

“Bonds are wasted space in our portfolio, and we want to have as few of them as we can get away with.”

“We are long-term investors, so we should have an equity-dominated portfolio.”

“International diversification is overrated. When you need diversification, correlations go to one.”

In 2010, we are hearing the following:

“Our pension fund is not a core part of our business.”

“Our portfolio should be first and foremost about matching our liabilities, not seeking returns.”

“Equities will play a smaller role in our portfolio going forward.”

“Equities are growth assets. We should put our equity money into faster growing economies.”

Why the extraordinary difference between today and 10 years ago? While it could be that the last 10 years have brought us closer to the fundamental truths of finance and we are finally asking the right questions, we would argue that the statements are reactions to their times. The decade to 2000 saw the S&P 500 rise 18.2% per year, far outpacing non-U.S. equities, which themselves outpaced bonds, which returned +6.8% per year. The decade to 2010 saw the S&P 500 fall 1.3% per year, with bonds giving decent returns of +6.5%. Within equities, only emerging markets made any real money for investors, with a return of +9.1% per year. Investors have a natural tendency to lose faith in asset classes or strategies that have not been working and gain confidence in those that have. That tendency is amplified by investment managers, consultants, and Wall Street, all of whom are in the business of selling new ideas. They know the ideas that will sell are those that either have worked or would have worked in the recent past, and they do a great job of parading those ideas in front of investors, usually with elegant-sounding ideas as to why they are the right solutions for the future. The result is that investors are quick not only to lose faith in assets and strategies that aren't working, but also to embrace assets and strategies that appear to offer a better way, often with too little critical thought going into the decisions.

Investment managers, consultants, and Wall Street are not going to change, so how can investors avoid doing in 2020 what they did in 2000 and may be doing again in 2010? In our opinion, a crucial part of why investors find themselves swayed so much by the winners and losers of the last cycle is that they lack a strong anchor to their investment beliefs. Fixing this may be far beyond the abilities of any one person, firm, or Lord knows, white paper. But we hope to share our experience that by asking a few basic questions about asset classes and strategies before deciding what role they will play in a portfolio, investors can have a better chance of separating worthwhile ideas from the rest, and have a better idea of when it is time to remove an asset or strategy than simply because it hasn't been working recently.

The questions we will present come in two groups of three: three questions to ask before doing any analysis to help guide thoughts about the asset class from a theoretical perspective, and three more to guide the analysis and help determine what the analysis is telling us.

In the body of the paper, we'll go through the questions and a few examples of how to put them to use. We will analyze equities, bonds, and commodity futures in some detail. We will then follow with shorter analyses of private equity, venture capital, and volatility and tail protection strategies. Each of these asset classes requires a somewhat different analysis, but the questions are relevant for all of them. This is not intended to be an exhaustive set of asset classes and strategies – the point, after all, is that there is no exhaustive set of examples, so we need to have a framework for dealing with new assets and new ideas. But by showing you some examples of putting these questions to work, we believe we can help you deal with the new ideas that will inevitably come to your attention over time, and provide a better anchor to help avoid getting your portfolio caught up in a damaging investment current.

The first triplet of questions is the following:

Would investors rationally buy this asset if they did not believe it would give returns above cash?

If investors would buy the asset in the absence of a risk premium, we cannot be confident that there should be one long term.

Where do the returns from this asset come from, and who funds them?

We need to understand the sources of return to properly analyze historical return data and we need to understand what entities are funding the return to give insight into their motivations.

Why would the funder of returns for this asset be willing to offer a return greater than cash in the long run?

If there is no good reason for the entities funding the returns of an asset to be willing to fund a return above cash, the sustainability of a risk premium is questionable.

In trying to understand the analysis, we have an additional set of three questions to consider.

Have the historical returns been consistent with the risk premium we expected?

If we thought there should be a risk premium and there wasn't or vice versa, perhaps we have missed something important about the asset class.

Have the sources of the returns been consistent with the returns achieved?

If we cannot fully explain where the returns have come from in an asset, we have definitely missed an important factor.

Has something important changed to make us doubt the relevance of the historical returns?

The existence of a historical risk premium for an asset and an understanding of where it came from are nice, but if something important has changed about those buying the asset, those funding the returns of the asset, or the characteristics of the asset itself, history may not be all that relevant.

Equities

Would investors rationally buy equities if they did not believe they would give returns above cash?

The answer to this seems unambiguously no. There is no obvious argument for holding stocks without an equity risk premium. Equities are volatile, they have no legally mandated cash flows associated with them, and they are the lowest rung in the capital structure in the event a company gets into trouble. While it is true that in a period of high or uncertain inflation equities provide a degree of protection against the loss of real purchasing power, the behavior of equities in inflation is not consistent and there are other, less volatile, assets that can be held for inflation protection – not least cash itself, as cash rates tend to mirror inflation rates except in cases of severe financial repression.

Where do the returns from equities come from, and who funds them?

The returns to equities come from the cash flows the issuing companies give out to shareholders. This could really be written as dividends rather than cash flows, as long as we recognize the payment received by shareholders when a company is purchased for cash as a special dividend. Stock buybacks are cash flows to shareholders that have value for the simple reason that they reduce the share count outstanding, thereby increasing the value of future dividends per share. Buybacks can therefore be treated either as a dividend or as a boost to future dividends, as long as this is done in a consistent manner through the analysis.

Why would the issuing companies be willing to offer a return above cash in the long run?

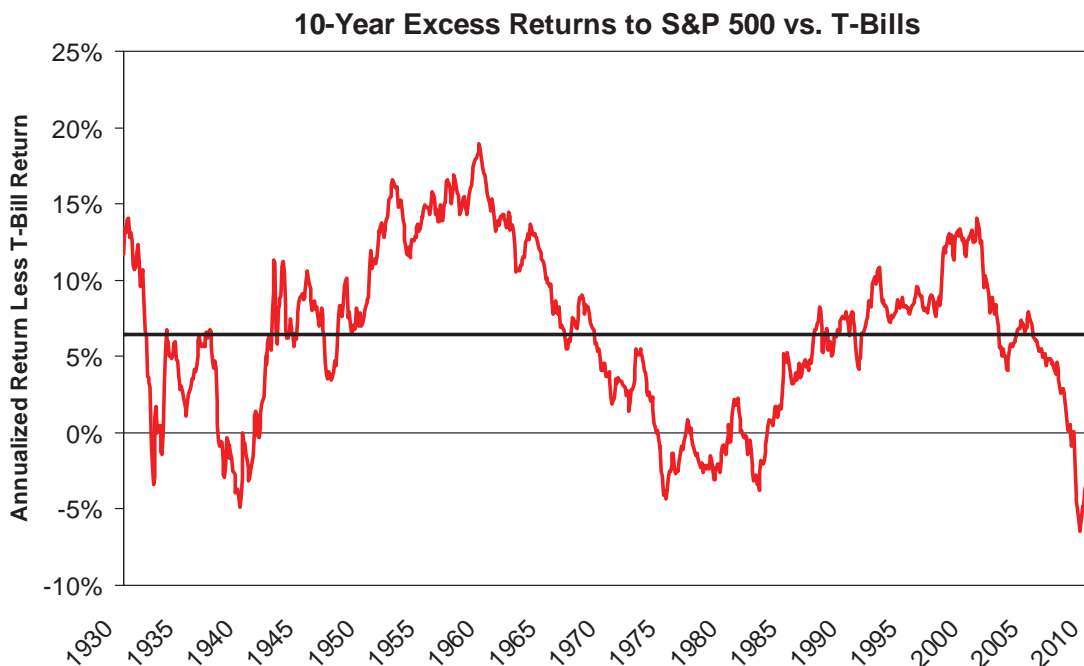
Equity is safe capital for a company. They allow it to make long-term, risky investments with less risk of bankruptcy. Equity is required for regulatory purposes for some industries and required in almost all cases of unsecured lending by potential creditors. Companies need equity. It is the most flexible capital they have and involves no refinancing risk. This flexibility is valuable and necessary for companies, and they should be willing to pay for it.

Our questions had straightforward answers in the case of equities, with the buyers of equities requiring a risk premium, the issuers willing to provide it, and a simple set of cash flows providing the returns. Now let's see how our theory stacks up against the actual returns to stocks.

Have the historical returns to equities been consistent with the risk premium we expected?

Point-to-point returns will not adequately tell us how reliable the equity risk premium has been. Instead, it seems more reasonable to look at the 10-year returns of stocks versus cash. If the risk premium is a reliable one, most 10-year periods should show a decent return premium, and the periods of underperformance shouldn't be too horribly long. You can see the 10-year excess returns of the S&P 500 versus T-Bills below:

U.S. Equity Returns over Time



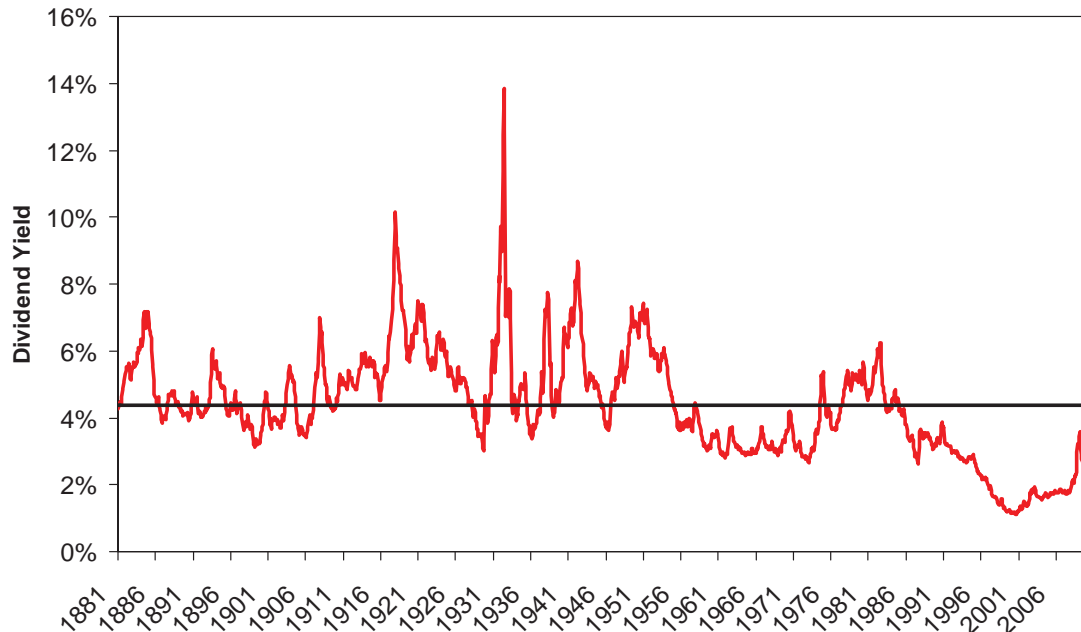
Source: Robert Shiller, Federal Reserve As of 6/30/10

The average equity risk premium for the rolling 10-year periods has been 6.4%. There have been a number of decades in which stocks have lost to cash, but the general level of the risk premium has been high, and none of the periods of underperformance have been excessively long – although the 1974-83 period is a bit long for comfort. All in all, the returns have been consistent with the risk premium we expected.

Have the sources of returns for equities been consistent with the returns achieved?

Since the returns to equities come from the dividends, the most straightforward thing to do would be to look at the dividends of stocks, as seen in the chart below.

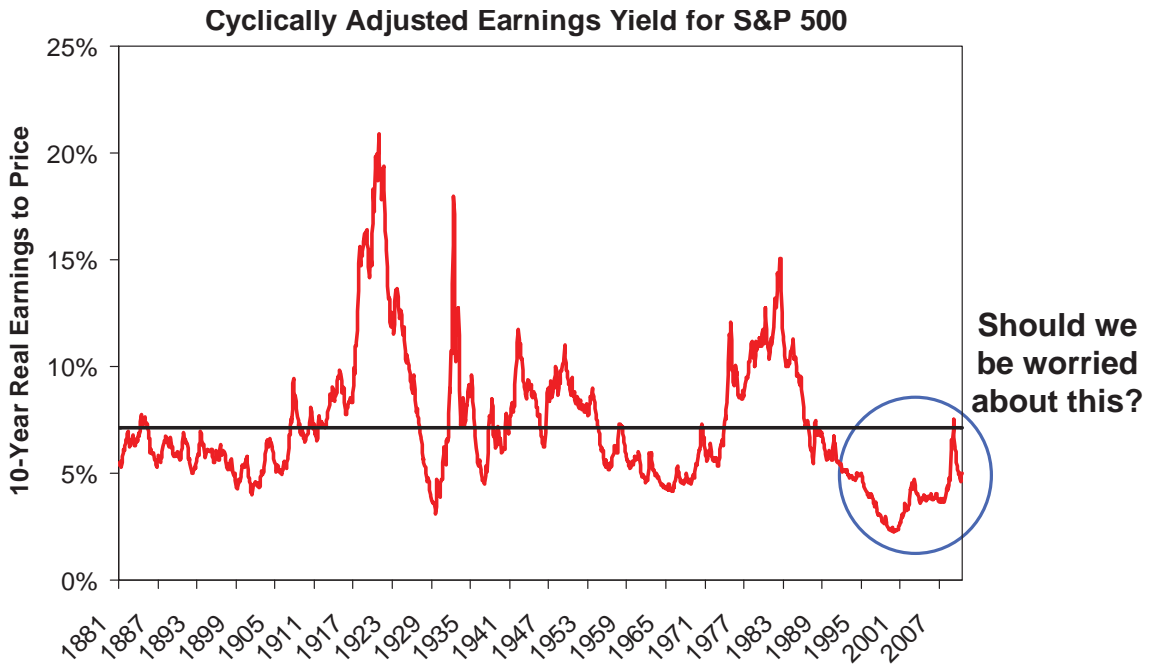
Dividend Yield for S&P 500



Source: Robert Shiller As of 6/30/10

But it turns out that this chart doesn't quite tell us enough. The average dividend yield has been 4.3%, but not only is this lower than the return of the S&P 500 for the simple reason that some of the return has come from dividend growth, but the dividend yield has also been lower than the long-term average for well over 20 years now. This could either be due to a change in payout ratios – if they have fallen, perhaps dividend growth will pick up relative to history – or higher valuations. It seems we would be better served by looking at the earnings, which are the source of dividends. Assuming corporations do something useful with the earnings they choose not to pay out as dividends, a cyclically-adjusted earnings yield will be a better guide to equity valuations than dividend yields will be. Here are the price/10-year average real earnings for the S&P 500.

Equity Valuations over Time



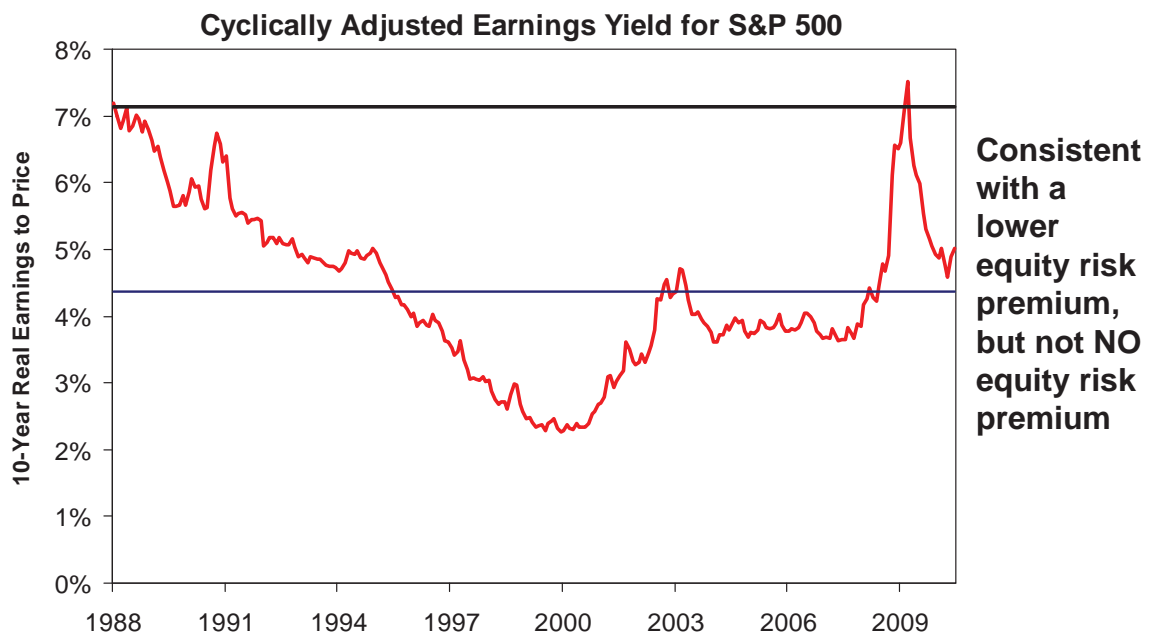
Source: Robert Shiller As of 6/30/10

This helps us somewhat. The average earnings yield of 7.1% is consistent with the returns of stocks, which answers our second question, but brings up an important issue for the third one.

Has something important changed that makes us doubt the relevance of the historical returns to stocks?

The answer to this one may well be yes. With the exception of one month in the winter of 2009, stock valuations have been below the historical average earning yield since 1988, averaging only 4.3%, as we can see below:

Equity Valuations Recently



Source: Robert Shiller As of 6/30/10

This could well be telling us that the returns from stocks will be lower in the future. We believe that much of this period has been an equity bubble and the future returns will be closer to historical levels, but since we believe that this will occur because average valuations going forward will be closer to historical levels, the implications of believing in mean reversion or not are not all that extreme. Either the last 20 years are a good guide to the future and equity returns will be around +4% real, or equity prices will fall to a level where returns will be higher.

This means that the equity risk premium will either be temporarily lower than history as equity prices mean revert, or permanently lower than history if they do not. Even if valuations do not revert, however, recent valuations have been consistent with a positive equity risk premium, just not as large a one as we have seen historically.

Bonds

Would investors rationally buy bonds if they did not expect they would deliver a return above cash?

This is a more ambiguous case than equities. For an investor whose future liabilities have an inflationary component, such as endowments and foundations, the answer may well be no – although even there, if the investor believes that nominal bonds will do particularly well in the event of deflation, they may be willing to. But for investors whose liabilities are nominal, such as many defined benefit pension funds, it can make sense to purchase bonds in the absence of any expected term premium. Indeed, it may make sense to buy bonds even if the expected return was less than cash, since it reduces the volatility of the assets relative to liabilities.

Where do the returns from bonds come from, and who funds them?

The returns from bonds come from their coupon payments and eventual principal repayment, which is funded by the issuing entities.

Why would issuers of bonds be willing to offer a return above cash to bond investors?

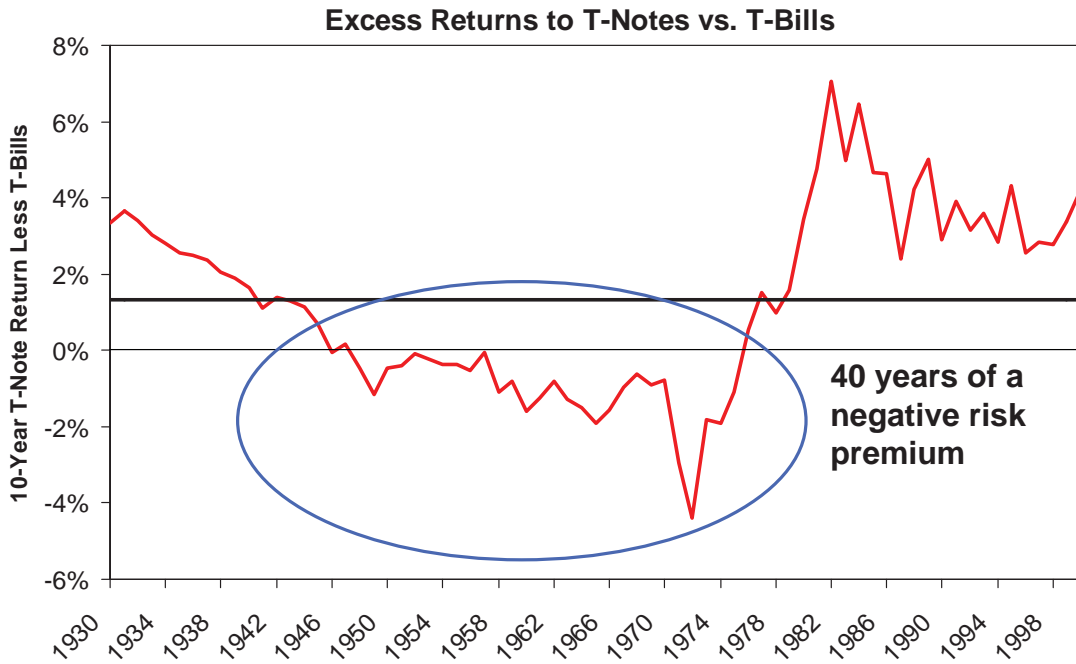
Long-term debt is a better match for long-lived assets. Real estate; infrastructure; and property, plant, and equipment investment generally have long lifetimes and are better matched by long-term debt than short-term – if it is not funded from equity.

Our questions leave us with some uncertainty with regard to bonds. Issuers seem to have a reason to be willing to fund returns above cash, but it isn't clear that investors will demand a term premium. Since the answers were ambiguous in this case, looking at history will be particularly helpful.

Have the returns from bonds been consistent with the risk premium we expected?

The historical term premium from bonds has been 1.3%, not particularly large, but still significant. What is worrying is the fact that from 1947 to 1976 every rolling trailing 10-year period saw bonds lose to cash. While no asset class is likely to have an utterly dependable risk premium, this is a 40-year period in which bonds consistently underperformed cash, and 40 years is too long a time for almost any institution to bear. On the other hand, the average risk premium over the last 30 years has been 4%, which is almost as high as the equity risk premium.

U.S. Bond Returns over Time

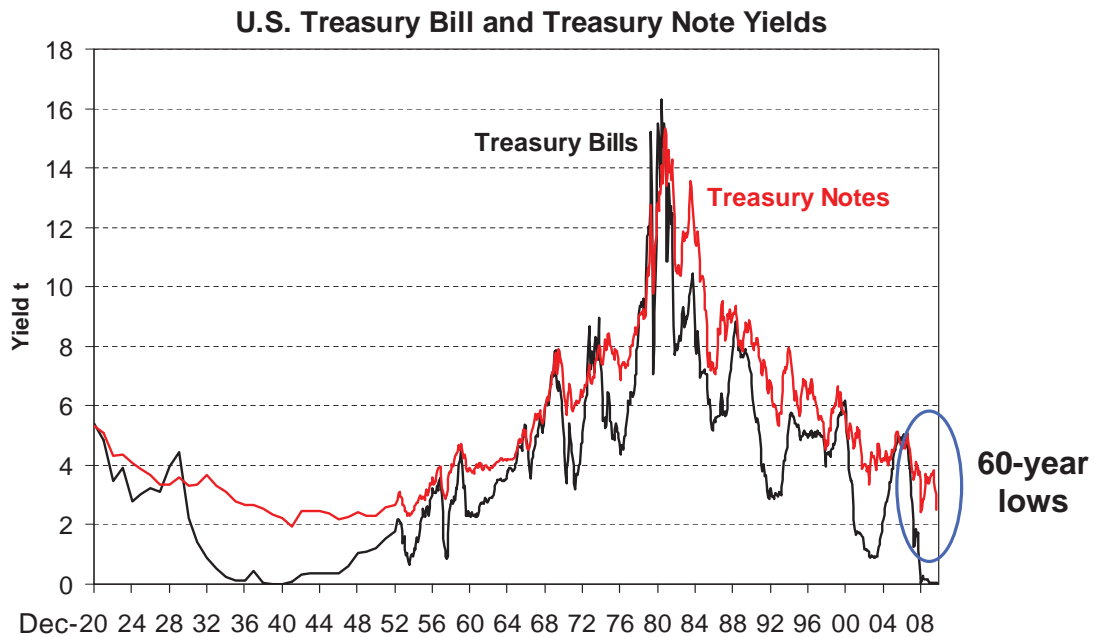


Source: Global Financial Data, Federal Reserve As of 1/31/00

Have the sources of returns to bonds been consistent with the historical returns?

The historical yields of bonds and cash are shown in the exhibit below.

U.S. Bond Yields Over Time



Source: Global Financial Data, Federal Reserve As of 8/31/10

The average yield on treasury bonds since 1920 has been 5.1% versus 3.7% for T-Bills. This is consistent with the returns we've seen. But one thing to notice is that from 1941-81, the period in which bonds consistently lost to cash, the yield premium of bonds over T-Bills was 1.3%, versus 1.4% for the entire period. This tells us that it is not sufficient for bonds to have a higher yield than cash for them to give a higher return. If the yields on both rise significantly, bondholders will lose out.

Has something important changed to make us doubt the relevance of the historical returns of bonds?

Strictly speaking, it doesn't look like anything unprecedented has happened, given that we have seen bond and cash yields at current levels before. However, the last time bond and cash yields were at their current levels was the 1930s and 1940s, and they ushered in an extended period of a negative term premium for bonds. Since the yield premium for bonds is higher than normal, at 2.4%, a zero or negative term premium would have to come from rising yields, but with yields not far off of their all-time lows, this does not seem overwhelmingly unlikely. And given that the existence of a forward-looking term premium for bonds was questionable from a theoretical standpoint – there may be enough price-insensitive buyers of bonds to bring the term premium down to zero or close to it – we would have to conclude that it would be dangerous to rely too heavily on a risk premium on bonds going forward.

Commodities

Would investors rationally buy commodity futures if they did not expect they would give a return above cash?

This is also a somewhat ambiguous case. For investors with real liabilities, commodity futures may provide valuable inflation protection. If investors believe that commodity futures have a high beta to unexpected inflation in particular, they may well be willing to buy them in the absence of a risk premium. Other investors would probably need to be enticed by a risk premium.

Where do the returns come from commodity futures and who funds them?

This is actually a more complicated question than with stocks and bonds. A commodity futures investment is not “funded” since an investor only needs to put up a small amount of initial margin. Therefore, part of the return comes from the investment of the cash underlying the notional investment. The other two sources of return are the change in the spot price of the commodity and the “roll yield” of switching from a near-dated future to one a month or two farther out.

In terms of who funds the return, the cash return is funded by the borrowers of the cash, but the rest of the return needs to be funded by whomever is short commodity futures. For every long investor in a futures contract, someone else must be short, and for every dollar gained by the long investor, there is a corresponding loss from the investor on the other side.

Why would the shorts be willing to fund a return above cash for a commodity future?

It depends on the nature of the entity that is short. If the short is a commodity producer trying to lock in a price for its output, it may well be willing to fund a return above cash. In the 1920s, Keynes explained the roll yield as an insurance premium that commodity producers offer to speculators in order to reduce the risk of the business. Since commodity production is a capital-intensive business, it can make sense for a producer to lock in a price even if that price is lower than the unbiased estimate of the future price it will receive for its output. However, the positive expected return to being long will happen only if there is an imbalance in demand for the futures such that the shorts have to “bribe” speculators to take the other side of their trades. Some commodity consumers may be in an analogous position with regard to their desires to lock in a price for their future commodity buying, and whichever side needs more futures will need to “bribe” the speculators to take the other side. Even if it seems historically that the hedgers have been net short, we will need to look out for anything that changes the dynamics between buyers and sellers.

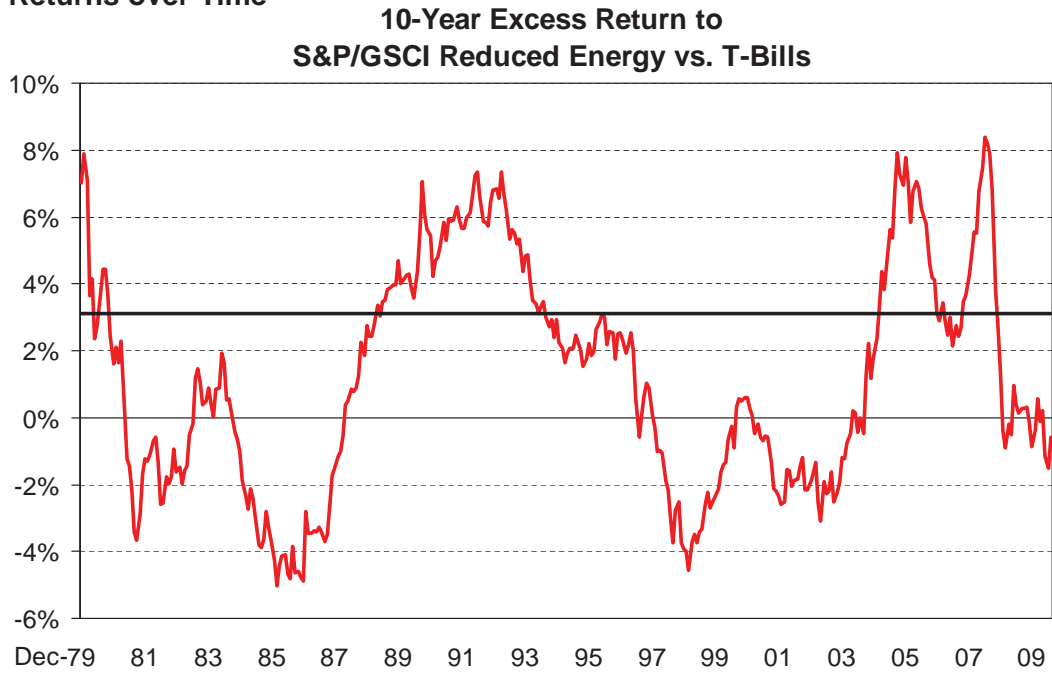
Therefore, this will be another case where the historical analysis may be particularly informative.

Have the returns to commodity futures been consistent with the risk premium we expected?

There is no universally agreed-upon benchmark for commodities, but the S&P/GSCI indices have as long a history as any and are investable today. The original GSCI Index has an extremely high weight in energy futures. The reduced energy

version of the index is closer to other commodity indices by giving a half weight to the production of energy, which brings the overall weight of energy down to about 50% as of October 2010. The chart of 10 year returns is below:

Commodity Returns over Time



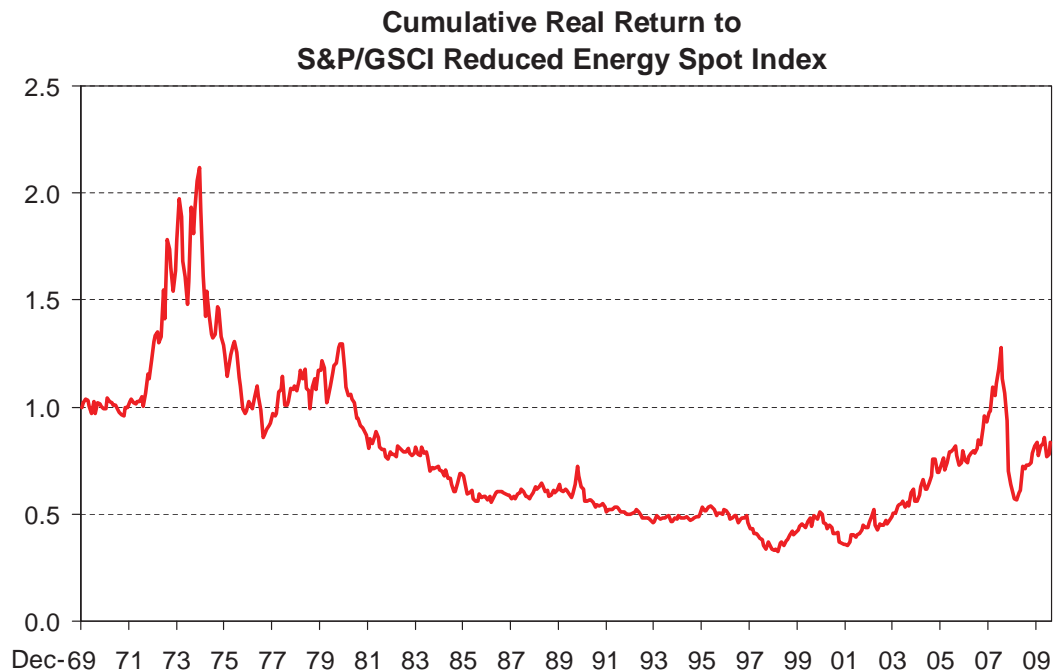
Source: Federal Reserve, Standard & Poor's As of 7/31/10

The premium has averaged 3.1% over the period, although it has been negative 40% of the time.

Have the sources of return been consistent with the returns achieved?

This is a harder question than with bonds, given the different sources of return. Here is the change in spot commodity prices since the start of the index.

Commodity Spot Price Return over Time

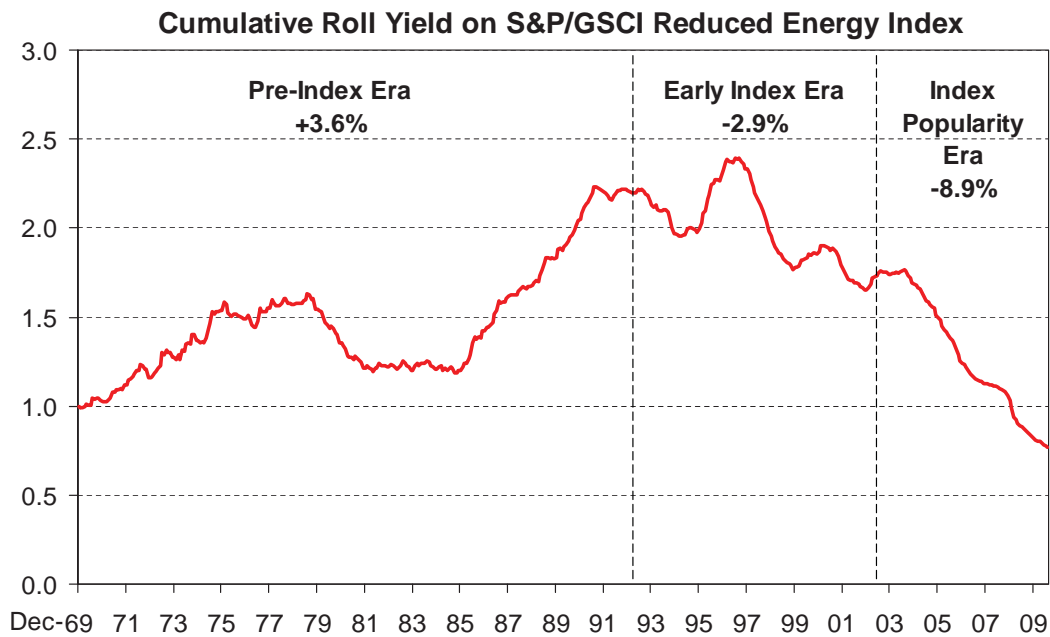


Source: Federal Reserve, Standard & Poor's As of 7/31/10

While there has been a good deal of volatility to this index, on a spot basis the index has not kept up with inflation. This isn't required for commodities to give a return above cash, since there are two other sources of return, a cash return and roll yield. We looked at cash yields earlier. They were quite high from the mid-70s until the mid-80s, but obviously they will not be able to provide much return in the near future.

We can see the roll yield below.

Commodity Roll Yield over Time



Source: Federal Reserve, Standard & Poor's As of 7/31/10

This return was strongly positive until the middle of the 1990s, averaging 3.6% per year from 1970-92. For the next decade it turned negative, giving -2.9% per year from 1992-2002. Since 2002 it has been even more consistently negative at -8.9% per year. These dates are not entirely random. 1992 was the year Goldman Sachs first created the GSCI indices. While the returns go back well before then, they were backfilled using the methodology Goldman created. Since Goldman would have been unlikely to promote an index that had given lousy returns historically, we may want to consider the earlier period subject to data-mining. And while Goldman Sachs created the index in 1992, there was not a lot of interest in it for the first several years. Barclays estimates that it was around 2002 when money in commodity indices crossed the \$10 billion threshold, at which point we could consider that the commodity indices were having a meaningful impact on the futures markets. This brings us to our third question.

Has something important changed that makes us doubt the relevance of the historical returns to commodity futures?

The answer to this seems unambiguously yes. Ever since interest in commodity indices became significant, the roll yield has been profoundly negative. This is consistent with our theoretical ideas of why the return premium should be there. If the imbalance in the commodity markets has shifted from being net short to net long, the group that has to “bribe” the speculators to take the other side for them is the buyers, not the sellers. This would lead to a negative roll yield, which is exactly what we see ever since the commodity indices became important. If cash yields and inflation were high enough, it would still be possible to expect a positive risk premium for commodity futures, but with cash yields at zero today, investors in commodities need to count on spot prices rising significantly faster than inflation just to get back to even. While this is certainly possible, it does not seem to be a recipe for a reliable risk premium for

commodities, to say the least. If the roll yield were to continue at -9%, spot commodity prices would have to outpace inflation by a wide margin to get us back to the zero return that cash currently offers. Looked at this way, it seems at least as likely that commodities will offer a negative risk premium as a positive one. While this may seem surprising, it is consistent with the fact that plenty of institutional investors are prepared to be long commodities, but almost none show a willingness to be short. Getting shorts to come in to take the other side seems like it would require a pretty significant “bribe” in the form of high expected return.

Extending to other asset classes

While the first three examples are some of the most straightforward assets to analyze, we can use the framework to look at other asset classes and even strategies that may or may not qualify as an “asset class.”

Private equity

Would rational investors buy private equity if they did not expect a return premium over cash?

This is a pretty straightforward no, but in the particular case of private equity, which has all of the drawbacks of public equity plus illiquidity, we should probably change the question to whether rational investors would buy private equity if they did not expect a return premium over public equities. While a case could be made that because private equity is not marked to market, it provides a certain accounting diversification from traditional stocks, few investors would admit to buying it for that purpose. It seems very likely that those who invest in private equity expect higher returns than from their public equity portfolios.

Where do the returns come from in private equity and who funds them?

The returns to private equity come from a combination of dividends paid while the company is private and a realization event when the company is eventually sold to another buyer or taken public. The dividends are funded by the company taken private, although a case can be made that in some instances they effectively come out of the hide of creditors of the company, who may wind up owning debt of a more highly levered entity than they originally bargained for. If they fail to put effective safeguards in to protect themselves, the dividends may well be a transfer of wealth from them to the equity holders. But the main source of returns comes from the eventual buyer of the company.

Why would the funders of the returns to private equity be willing to fund a long-term return in excess of public equities?

They would not do so intentionally. If private equity works, it works by exploiting inefficiencies in the public markets. Either the private equity firms systematically entice public shareholders or other companies to pay more for the companies than they could have gotten them for when the companies were taken private to begin with, or they systematically run those companies better than they were run as publicly held firms. Private equity firms may be able to squeeze some additional returns out of creditors, who wind up giving away a more valuable “option” in the form of bankruptcy, than they originally expected. While these inefficiencies may persist in the long term, it would be easy to conclude that private equity is more akin to active management of equities than a traditional asset class, because its returns crucially depend on the managers having particular skill.

Have the returns to private equity been consistent with the risk premium we expect?

This is hard to answer, because there is no widely acknowledged index of private equity returns. Some researchers have found returns greater than public equities, although perhaps not by more than the leverage of private equity would suggest. Others have concluded that returns have been significantly lower than public equities.¹

¹ Lerner, Schoar, and Wong in “Smart Institutions, Foolish Choices” gives the IRR to buyout funds as -0.4% annually, with even pre-1999 funds giving an IRR of 3.1%, while Phalippou and Zollo in “The Performance of Private Equity Funds” gives an IRR of 16%, versus 15.3% for the S&P 500 over the same period. This kind of dispersion in returns makes it difficult to make much pretense of analyzing the return data.

Have the sources of returns been consistent with the returns we have found?

This is impossible to say, because we don't actually have returns to look at.

Has something important changed to make us doubt the relevance of the historical returns to private equity?

Despite the lack of historical returns to analyze, the answer to this is almost certainly yes. The amount of money invested in private equity funds is a large multiple of what it was 15 or 20 years ago. If private equity indeed relies on inefficiencies in the public markets for its returns, the managers will have to find far more misvalued/mismanaged companies (or poorly written debt indentures) than they needed in the past. Even assuming that returns were acceptable historically, we cannot assume they will be going forward.

Venture Capital

The analysis of venture capital is similar to private equity in many ways, but there are important differences as well. Let's go quickly through this asset class.

Would rational investors buy venture capital if they did not expect a return premium over cash?

Just as with private equity, it is likely that investors would insist on a return not only above cash, but above traditional equities as well, given the high risk and illiquidity in this asset class.

Where do the returns come from in venture capital and who funds them?

The returns come from the eventual sale of the company at a higher price to the public markets or another established company. In the case of venture capital, it is generally assumed that the higher valuation will come about because the company has grown significantly since the venture capital investment. There is little or no likelihood of interim cashflows from the company back to investors.

Why would the funders of the returns to venture capital be willing to fund a long-term return in excess of public equities?

Here the answer is different than that for private equity. Depending on how one looks at it, either the entrepreneurs are funding the return by being willing to sell equity to venture capital firms at low valuations, or the future buyers of the company are willing to pay up to have someone else worry about the company while it is in its early stages of growth. Either way, it seems there may be rational reasons for the returns to persist. Entrepreneurs need risk capital to grow their companies, and if the public markets and established companies are unwilling to provide it early in the company's life cycle, they need the venture capitalists to step in and help. The venture capitalists may also have particular expertise in helping companies at these early stages of growth. While this is somewhat analogous to the skill private equity firms may have in running companies, it seems more plausible that the experience of shepherding numerous companies through the process gives insights that entrepreneurs would not naturally have than it is that private equity firms know something that the managements of publicly held mature firms cannot learn.

Have the returns to venture capital been consistent with the risk premium we expect?

Just as with private equity, we lack a good, universally agreed-upon benchmark for venture capital. The same sources that disagree on the returns for private equity disagree on the returns for venture capital, although they find returns at least marginally higher than for private equity.²

² Lerner, Schoar, and Wong in "Smart Institutions, Foolish Choices" gives the IRR of early stage venture capital funds as 13.8% annually, although it is much higher at 60.5% for pre-1999 funds. For later stage venture capital they get a 7.6% IRR, with 25.6% for pre-1999 funds. Phalippou and Zollo in "The Performance of Private Equity Funds" give an IRR of 16.6%, versus 15.3% for the S&P 500 over the same period.

Have the sources of returns been consistent with the returns we have found?

Just as with private equity, without actual returns to look at, this is a meaningless question.

Has something important changed such that the historical returns to venture capital may no longer be relevant?

The answer here is similar to that for private equity. There is far more money invested in this asset class than was the case 15 or 20 years ago. This may have bid up the prices that venture capital firms are forced to pay for stakes in young firms. There are also relatively large numbers of “angel” investors who compete with venture capital firms. This further increases the competition for deals. We cannot tell a priori whether this would have destroyed the excess returns to venture capital, but even though there seems to be a good economic case for the need for the asset class, and both sides have reason to demand (or allow) a risk premium to persist, the weight of money must be a worry.

Volatility or Tail Protection

Long volatility strategies and tail protection strategies have become popular since the Global Financial Crisis. It is not clear that they qualify as “asset classes,” but we can still put them to our questions and try to see what we can learn about them.

Would rational investors buy a volatility or tail protection strategy in the absence of an expected premium over cash?

The answer here is yes. Rational investors who are concerned that their portfolios will do badly in a volatile environment or, specifically, one in which tail events are occurring, would rationally invest in these strategies without any risk premium. In fact, they may well be willing to invest despite a negative risk premium, since the strategies provide valuable insurance.

Where do the returns come from in volatility and tail protection strategies, and who funds them?

These strategies generally come down to derivatives contracts in which the other side of the contract will have to provide whatever cash flows accrue to the investors. Insofar as the derivatives are unfunded, there may be a cash return as well.

Why would the funders of the returns be willing to offer a long-term return above cash?

It is pretty clear that no one would rationally fund these returns to give a risk premium. If volatility/tail risk contracts pay off when traditional portfolios are doing badly, it is difficult to envision investors who would want to take extra losses at such a time, unless they were being paid a risk premium for doing so. While it is possible that investors have systematically underestimated the likelihood of low-probability events, it does not seem intuitive that they would continue to do so indefinitely. If they did, it would certainly be a form of market inefficiency that would be less likely to persist if the amount of money exploiting it were to grow large.

Have the returns to volatility or tail protection strategies been consistent with the risk premium we expect?

We do not have good historical returns to look at in the case of these strategies, but it is clear from just the first three questions that anyone investing in this area who expects a return even as high as cash must be putting faith in a manager’s ability to exploit market inefficiencies. Furthermore, an investor who has good results with such a manager needs to worry if that manager’s assets under management were to grow significantly, or if others catch on to whatever mispricing the manager is exploiting. This effect could either come from other investors copying the first manager or counterparties being unwilling to transact at similarly attractive prices after having been burned.

This need not make an investment in the strategies a bad idea. Even if the expected returns are negative, an investor with a higher-than-normal aversion to volatility or drawdown might well want to invest, and those investing in active security selection strategies believe they have an ability to find managers that can beat the odds.

Conclusion

We could go through plenty of other examples of asset classes and strategies, but the point of this paper is not to be exhaustive. It is, rather, to suggest a way for investors to look at asset classes and related strategies and make reasonable conclusions about what kind of long-term returns to expect from them. Hopefully, the examples we have gone through span a broad enough spectrum of assets that it is reasonably clear how to do this analysis for all of the asset classes in a typical institutional investor's portfolio.

Equipped with a strong anchor for their investing beliefs, CIOs can better analyze the new ideas that come across their desks. They can also do a better job of defending the truly good ideas in their portfolios against investment committee members and other constituents who will argue that a given idea "just isn't working" and should be scrapped. Furthermore, they can understand some of the circumstances that should cause them to consider rethinking an idea that is no longer likely to prove useful.

This level of analysis is not capable of great precision in forecasting future asset class returns. But for many purposes, determining whether an asset class is likely to give a return premium is more important than estimating exactly what that premium will be. Early adopters of a long commodity futures strategy who knew to look out for an increase in the money invested in the strategy and a sea change in roll yield could have moved away from the asset class as the circumstances changed, or at least begun to rethink the role it served in their portfolios. Investors in a volatility strategy who realize that just breaking even in the strategy in the long term would be a significant success are less likely to be disappointed by the eventual returns and less likely to put an excessive portion of their portfolios in the strategy. And pension fund managers who are simultaneously moving to liability driven investing, which causes them to buy bonds regardless of valuation, and risk parity, which causes them to buy bonds assuming a risk premium will persist for the asset class, may recognize the essential tension between the two ideas.

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