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Trying to Interpret the Many Risk Signals

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What a Canada Day long weekend! The weather here (in the GTA) was simply perfect….sunny and warm for all three days. Like most people, I soaked in the sun and the outdoors. And in my spare time, reflected on one issue we encounter almost daily in the news — managing risk.

Since 2008, the world has become focused on how to control and contain risk. Last month, we all learned of JPMorgan's surprise trading losses exceeding $2 billion. That figure has since ballooned and calls into question the firm's risk models and underlying assumptions.

In Canada, risk was central to a recent decision by Finance Minister Jim Flaherty to discourage homebuyers from accumulating too much household debt. New rules were introduced that lowered the maximum amortization period for government insured mortgages from 30 to 25 years, ended government insurance on homes costing over $1 million and capped loans for refinancing at 80% (down from 85%). These changes were supported by a fact that the household debt to income ratio had exceeded 150%, which is an alarmingly high figure.

Last July, I wrote about rising Canadian home prices and its inevitable end. Since then, the Vancouver market has cooled slightly. But that's not the case elsewhere. In the GTA prices are still rising and bidding wars still prevail.

Last year, my key point was that real estate (specifically home ownership) had somehow morphed into the quintessential "no-risk" investment. Many people became convinced that owning a home was a path to wealth because house prices never go down. Leverage up via a mortgage and you multiply wealth immensely. Wasn't it cheap and ample credit availability that got the U.S. into it's current mess. Maybe Flaherty was worried Canada might be next?

The Holy-Grail of the investment world is the promise of an asset with a high return and no risk. But such an investment is mythical. There's no free lunch.

So I ask myself — are we in a weird period where certain assets are mispriced due to our perceptions of risk. Are we living in an anomaly?

Clearly, we are in the midst of a multi-year global economic slowdown, debt and productivity problems plague parts of Europe, the G20 is facing fiscal and monetary challenges and a constant stream of negative news is bombarding us daily. Add geopolitical upheavals in several parts of the world and it's understandable why so many have a zero-risk appetite.

This risk aversion (fear) has caused massive capital flows towards "safe" North America resulting in interest rates that have fallen to unprecedented levels. Yields on 30-year Government of Canada bonds are under 2.5% while US Treasury's are 2.7%. At these levels, investors aren't even covering their inflation and tax costs. They're sure to lose purchasing power over time.

An abnormally strong urge to avoid risk explains why certain assets are in such big demand while other assets are being shunned.

A recent article said equity market volatility was preventing investors from buying stocks even though they weren't expensive. Seems investors are waiting for things to return to 'normal', or evidence that returns will be in the 7-11% range. But if history is a guide, returns in this range occur just 13% of the time.

Institutions too are shifting their view of risk and have become more focused on liability matching. The result is lower allocations to public equity and more alternatives.

Don Coxe once said "the greatest opportunity comes from an asset class where those that know it best, love it least." Shifting demand due to risk perceptions can result in assets we love becoming over-priced. While assets we despise become bargains. And my gut says this is happening again right now. ◻

Inside this issue:

Happy Birthday Canada:

On July 1st, Canada turned 145 years young. Having travelled coast to coast for much of my career, I can easily and truthfully say this is a wildly beautiful country filled with diverse landscapes and really wonderful people.

We are blessed with abundances in many areas and a diversity in our cultures. We accept change without the need for violence or social unrest. And these past few years, we have skirted many of the big economic problems that have afflicted so many other nations.

I am proud to be a Canadian and look forward to sharing many more birthday's with all of you.

ASI — What we do:

Alternativ Solution Inc. offers capital markets analysis to pensions, endowments, financial institutions and the asset management industry.

ASI focuses on the asset side, working with clients to achieve better results while lowering risk. Past projects include developing investment policies, asset mix audits, LDI, global and domestic manager search and portfolio transition.

....Cheers, GMK