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RESEARCH

Stabilising and destabilising strategies

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Orthodox economic thinking encourages investors to welcome any new asset management product as a positive contribution to a competitive marketplace.

This attitude has resulted in a proliferation of asset management strategies in recent decades. At the same time, it is commonly assumed that the only relevant measure of a strategy's success is whether it "adds value", typically assessed by comparing recent performance against a benchmark index. As a consequence, the social utility of an ever-expanding asset management industry, and the social costs imposed by certain types of strategy, are largely ignored.

As the asset management industry has grown in size and complexity, attempts to classify investment products have had to evolve. Taking equities as an example, the value / growth categorisation that was popular in the 1990s and early 2000s has been augmented to include styles (or factors) such as momentum, quality and low volatility. Investors have also separated equity strategies based on their geographic focus, their expected deviation from a benchmark index (tracking error), and more recently on the extent to which they incorporate sustainability considerations.

While these different approaches to categorising asset management products are undoubtedly helpful, they ignore an important but rarely considered characteristic of investment strategies: their potential to create stabilising or destabilising market dynamics.

In the language of systems theory, a strategy is considered to be "stabilising" if it introduces a negative feedback effect that reduces or counteracts the impact of other influences on a system, thereby moving the system towards an equilibrium.

By contrast, a strategy is viewed as "destabilising" if it introduces a positive feedback effect that amplifies the impact of other influences on a system, thereby contributing to larger fluctuations and movements away from equilibrium. In the context of financial markets, we describe stabilising strategies as those which tend to move asset prices towards fair value, and destabilising strategies as those which move asset prices away from fair value.

> *"An important but rarely considered characteristic of investment strategies is their potential to create stabilising or destabilising market dynamics."*

While we accept that this description – resting on an unobservable fair value – poses some challenges for classifying different investment strategies as stabilising or destabilising, we believe it is nevertheless possible to make some broad generalisations. In particular, we argue that long-term investors making a carefully thought-through assessment of the future cashflows arising from an asset (what we call "cashflow investors") will typically exert a stabilising influence on markets. This is because they will tend to act in a counter-cyclical fashion – they buy when market prices are below their estimate of fair value and sell when they are above – creating a negative feedback effect that helps to move the market towards an approximation of fair value.

Conversely, investors who are focused solely on

past price movements, who make no attempt at an assessment of fair value (what we call "price-only investors"), will typically exert a destabilising influence on markets. This is because they tend to act in a pro-cyclical fashion – they buy assets after their price has risen and sell after their price has fallen – creating a self-reinforcing positive feedback effect that moves the market away from fair value. The destabilising nature of price-only strategies is most obvious in rising markets when they buy the strongest and shun the weakest performers, contributing to overvaluations (at the stock, sector and market level) and ultimately inflating asset price bubbles.

Destabilising market dynamics in action

In practice many strategies incorporate both stabilising and destabilising elements: quant, smart beta and alternative risk premia strategies, for example, often explicitly include both value and momentum signals (amongst others) in an attempt to improve risk-adjusted returns.

Investors therefore need to look under the bonnet of their portfolios in order to assess the extent to which their managers may be contributing to destabilising market dynamics.

However, strategies that are explicitly designed to respond to past price movements are not the only drivers of destabilising market dynamics. An equally important form of price-only investing comes from the performance-chasing behaviour of both asset managers and asset owners. For asset managers this can arise from two sources. First, tracking error constraints force managers to control the extent to which their portfolio deviates from a benchmark index, resulting in the need to buy stocks that experience large price rises.[1] Second, and perhaps more insidiously, portfolio managers know all too well that a sustained period of underperformance will lead to outflows from their strategy, impacting the profitability of the wider firm. Career risk therefore acts like an unwanted invisible hand, encouraging managers to buy fashionable stocks that they may not like, in order to reduce the risk that continued underperformance leads to investor outflows.

At the asset owner level, the response to emerging performance data also displays a performance-chasing bias. Retail investors are well-known for their pro-cyclical behaviour, but this is also true of institutional investors who closely monitor their managers' performance versus a benchmark index and feel obliged to respond to a run of poor performance. The effect of such monitoring approaches is that investors fire managers who have experienced a sustained period of underperformance and hire managers who have recently experienced a period of outperformance.[2]

> *"When markets become heavily influenced by price-only investors, asset prices can become wholly detached from any reasonable assessment of fair value."*

Towards less dysfunctional markets

Some will argue that price trends are a natural, even essential, trait of financial markets. And to the extent that trends are, at least in part, a behavioural phenomenon hard-wired into human thought processes, this may be true. However, when markets become heavily influenced by price-only investors, asset prices can become wholly detached from

[1] Price rises are more important than price falls in this context: when a manager has an underweight position in a stock whose price doubles, the absolute size of the underweight position also doubles; when a manager holds an overweight in a stock whose price halves, the absolute size of the overweight position also halves.

[2] The mechanics by which these fund flows contribute to momentum in markets have been described and studied in detail in Vayanos and Woolley (2013) An Institutional Theory of Momentum and Reversal.

any reasonable assessment of fair value, ultimately contributing to misallocations of capital, rent extraction and asset price bubbles. It follows that markets in which prices are largely determined by stabilising cashflow investors will be less socially damaging than markets in which destabilising price-only investors predominate.

The implications for investors will depend on their time horizon and the extent to which private and social factors drive their decision-making. Building on the argument outlined above, we draw out three broad conclusions:

1. Performance-chasing behaviour, whether driven by tracking error constraints or career risk concerns, is both privately and socially damaging in the long run. The private cost is illustrated by the substantial gap between the average fund manager's reported returns (the time-weighted return) and what the average investor achieves over time (the money-weighted return) – the gap being driven largely by performance-chasing hire and fire decisions.[3] We recommend that investors avoid strategies constrained by a tracking error target; identify and avoid managers that are prone to career risk and performance-chasing behaviour (via both quantitative and qualitative assessment); and enhance their own decision-making processes to avoid performance-chasing manager selection decisions.

2. Price-only strategies can be privately profitable, but are socially damaging, particularly when pursued by a large weight of assets. The empirical evidence in support of momentum is unequivocal: momentum appears in US equity data going back over 200 years and has over 20 years of out-of-sample evidence across many different markets and regions since its initial discovery in the early 1990s.[4] However, momentum and trend-following strategies act as a destabilising force in markets, helping inflate asset price bubbles and ensuring that prices remain detached from fair value for sustained periods of time. The social costs arise in the aftermath of asset price bubbles (often wreaking destruction on the real economy) and via the negative effects of asset mispricing (such as capital misallocation and rent extraction). We believe that long-term investors – especially those with a focus on sustainability and social responsibility – should consider reducing their exposure to momentum and trend-following in all its forms.

3. Cashflow investors – which includes value, growth and quality strategies that are completely benchmark unaware – can be both privately profitable and socially beneficial in the long run. As with any active approach, the private benefit to cashflow investors will be contingent on effective manager selection and a patient mindset. The social benefits derive from the helpful side-effects of more stable and efficient markets.

We believe that an assessment of the social costs associated with different approaches to asset management is long overdue and we hope that the distinction between stabilising and destabilising strategies will help bring this issue into focus. We encourage asset owners to consider the extent to which their existing portfolios may be exposed to different forms of price-only investing. A meaningful shift in the approach adopted by large pools of capital could reap substantial private and social benefits.

If you would like to discuss any of the ideas raised in this paper please contact us at:
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[3] Hsu, Myers, Whitby (2015) Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies

[4] Asness, Frazzini, Israel, Moskowitz (2014) Fact, fiction, and momentum investing

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