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Alternative Asset Classes – Unlikely to End Well

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Yields have turned negative for some supposedly risk free asset classes, and in the U.S. savers have seen rates at generational lows. Institutional investors, in particular, are faced with regulatory floors on rates that must be credited to policy holders. Insurers with business written 30 years ago may have guarantees as high as 6%. This creates a challenge when the 10-year Treasury is in the 2% range and spreads are not wide.

Alternative asset classes are being offered to "solve" this problem. Whether it is junk bonds backing shale oil firms or timber assets, investors are reaching for yield. The phrase "no free lunch" comes to mind. The arguments used to justify these assets, which arguably have diamonds in the rough if you have the expertise, are diversification (lowers risk) and yield (more risk, more return). Junk bonds are a great example. If you are Howard Marks and have spent your life learning about distressed assets, you look forward to times like these. If you are not, then actions by the herd are likely to lead to a bubble that eventually bursts.

Another trick some investors are using is to invest short. While they hype their asset-liability management framework publicly, in reality they are keeping their assets dry (in cash) so they can pounce as soon as rates rebound. Some have been in this position for several years. Others are moving out the curve, trying to take the extra yield from longer assets and often doubling down by buying longer and less credit worthy bonds. This increases their ALM risk.

These are all methods of market timing, and when the herd all tries this at the same time it rarely ends up happily for the investors. The intermediaries are happy because their incentive is to increase transactions. LET THE BUYER BEWARE!

It is tough to be a saver right now. Be smart about it. Avoid leverage, and stick to asset classes you understand.

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