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Hope Is Not an Investment Strategy

By James Beadle

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This year's Nobel Prize for Economics was awarded Oct. 14, to a trio of U.S. economists credited with contributing to the understanding of long-term asset prices. To anyone awake who is involved in the real-world allocation of money for investment in equities and other publicly traded securities, this news was alarming. If the Nobel committee really wanted to acknowledge expertise in portfolio management, it would have done better to give the award to almost any Russian investor.

It is true that the winners — Robert Shiller, Lars Peter Hansen and Eugene Fama — have contributed greatly to the theories that continue underlie common investment processes. But in the post-crisis era, it is time to question the legitimacy of some of the founding blocks of theoretical asset pricing and investment planning, which were based on rational, efficient market theories. For their part, Russian investors put less focus on theory and statistics and often come away with a more rigorous intuitive strategy.

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short-term investment strategy is how well it maps the behavior of risky asset classes.

The asset management industry in Russia is on the cusp of a massive expansion as government incentives and crises in the Old World, most recently the threat of default by the issuer of the world's global currency, reduce the attractiveness of parking money offshore in foreign-currency holdings. With this in mind, it is essential that Russia's leading investment management firms develop effective post-crisis investment solutions, rather than being swayed by the biases of Western economists who have made very mixed contributions to what might well be called the "impossible science." Russian asset managers might consider starting with a clean sheet and building solutions based on the actual dynamics of asset prices. This is what their clients already do.

As the world globalizes and computers grant us easier ways to trade and to monitor investments, it is perplexing that the Nobel committee has again endorsed the rationale of allocating a part of your savings to equities and a part to bonds, then gradually shifting the weightings as you age. True, this strategy remains the standard in the developed world, but it has singularly failed to provide savers there with wealthy, stress-free retirements. This investment theory was invented in the 1950s and 60s and has been thoroughly debunked by the markets of the past 13 years, which have yielded investment returns starkly at odds with expectations.

Russian investors have a different approach. Their experience of liquid capital markets is far more limited. Remember that the RTS Index is less than 20 years old. But they have already lived through a series of crashes and crises. As a result, many wealthy Russians reject Western investment models, but interestingly they adhere religiously to the most important investment principals: They buy cheap and sell at higher prices. This approach may sound obvious, but it takes unbelievable patience and even then it is incredibly difficult to achieve. Russians are highly risk averse, but they buy risky assets in times of turmoil, a logical combination of characteristics that Western banks systematically fail to understand.

These Russian idiosyncrasies are the natural outcome of crisis experience. Russian investors have learned not to park their money in risky assets, exposed to the risk of a so-called black swan event, an unexpected development that causes prices to plunge. Instead, they wait in cash, and when such an event comes, Russians step in and buy at steep discounts. While this is happening, supposedly sophisticated Western money managers struggle to find ways to exit their "long-term value" investments. Of course, this approach wreaks havoc with the economy and with Western banks' risk models. But wake up global banks, this is fundamental investing in action. Buy when prices are cheap.

What is curious about this short-term Russian strategy is how well it maps the behavior of risky asset classes. Russian investors intuitively know that the market is unpredictable

and inefficient and that correlations are impossible to forecast. Their approach to investing takes these issues into account. Equity price movements are proven to exhibit sharp and deep corrections, followed by gradual recoveries. If investment academics could embrace this idea and convert it into real-world solutions that provide investors with attractive returns, then we would be looking at real Nobel Prize-worthy material. And if Western banks could grasp that Russians are, in fact, at the leading edge of intuitive investment strategy, then they, too, might find ways to benefit. Not only would they have the potential to capture the business of a dynamic, cash-rich investor group, they would also have the chance to learn strategies that could help better preserve wealth in their home markets.

The Nobel Prize committee can salute as much pre-crisis economic work as it wants. Yes, we should recognize these pioneering economists' efforts and contributions. And to be fair, Robert Shiller, one of this year's winners, has contributed to post-crisis finance as well, with research on the sentiment shifts that cause bubbles. But how can we continue to commend the conclusions developed in the pre-crisis era, after the world has proven the idea of rational, efficient markets to be such a naive thesis?

How many more investors have to lose their savings before the asset management industry eschews outdated systemic models for pricing risk and allocating capital? Next time your so-called investment advisor calls you to recommend a structured product with hidden margin or a fund or other allocation strategy that gives you long-term risk exposure in hope of incremental gain, pause for thought. Remember that just avoiding the worst 10 days of the Standard&Poor 500's since 1950 more than doubles your potential return, highlighting that "buy and hold" is an inherently risky approach.

You should never get pushed into another hopeful posture. After all, hope is not a strategy, as every wise tactician knows. Ignore those Nobel laureates. Remember that former winners Myron Scholes and Robert Merton worked for Long-Term Capital Management, the most infamous hedge fund in history, which was wiped out when the financial markets collapsed as a result of Russia's 1998 crisis.

Russia's goal to turn Moscow into a global financial hub is moving slowly, but the country's difficult history has already allowed it to accumulate considerable investment know-how. The professional investment community has an incredible opportunity to bring Russia to the forefront of one of the world's most stimulating industries. The next Nobel prize in the sphere of asset pricing could fairly go to almost any risk-averse Russian investor.

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