

Crowded trades and unintended consequences

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Our approach to investment is based on two simple pillars:

- buy growing cash flows at reasonable prices
- diversify by buying assets that become more valuable when investors get nervous

We cannot forecast how and when market volatility will occur, however we can ensure that we are not allocated to crowded trades which do not meet one of our two pillars.

Investment markets have evolved over the past 25 years as computing power has allowed algorithmic trading, the trading of patterns, to become a more prevalent feature of market behaviour from day-to-day. For us, and our clients, the important question is whether the market volatility that occurred earlier this month was in fact unusual. We would argue not.

We wrote about our longer-term approach recently. Now we feel the time is right to delve deeper into how events such as the recent market volatility play out for our approach, and to consider why it is important to understand and manage these risks before they come to fruition.

The recent market volatility was driven by the need for certain investors to sell holdings during a period when most buyers were away – the annual summer recess. This led to dramatic falls for certain equities and certain other assets. The timing of when forced selling would occur is difficult to predict, however, the summer months have, over the past decade, become a recognised time when volatility such as this has occurred. Trading volumes are generally low, and desks are often staffed by less experienced decision-makers, which are perfect conditions for extreme price movements.

At its core, owning too much of an asset that you cannot value for its cash flow leaves it vulnerable to steep falls when sentiment changes. Japanese equities and crypto assets are two such investments at present. Both have risen steeply without a cash flow valuation argument to back them up. They became crowded trades as investors bought these assets as the narrative became more and more compelling as they rose. We own neither of these assets in our strategies.

Most investors can now borrow to invest, they can also 'sell short' assets they think will go down and leverage assets they think will go up. The important word in the previous sentence is "think". When they are wrong, they have to repay their borrowings (technically known as a margin call) and so they become forced sellers of assets. This often leads to unintended consequences as they may sell other assets where they have made a profit to repay their borrowings rather than sell the speculative asset which has fallen in value. This human trait leads to a short-term fall in other equities: namely US technology stocks this time around.

Fundamentally the difference with our exposures in Tacit strategies is that they rebound in value relatively quickly as they have cash flows backing up their valuations. Not all other assets exhibit this trait and can, therefore, leave investors with a permanent impairment of their capital as they got sucked in to what should be defined as a trade rather than an investment.

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