



No such thing as a risk-free asset

By Elisa Trovato
27 September, 2011



Giordano Lombardo

Investors may search for safe havens, but with so much uncertainty in the markets it is impossible to hedge a portfolio against all possible outcomes

In today's uncertain markets, every investor is looking for so-called "safe havens", but the idea itself of risk-free assets no longer exists, according to Giordano Lombardo, Group CIO at Pioneer Investments.

"The very concept of risk-free assets, one of the basic tenets of model portfolio theory but also of the daily practice of investors, is called into question," maintained Mr. Lombardo, speaking at this year's European Colloquia Series on Lake Iseo, Italy. "The world is very different from the past and it is very hard to define any asset as risk-free."

Western investors and asset managers have traditionally considered government bond yields as the benchmark risk-free interest rate, against which other asset classes were to be measured, but today it is debatable whether even US Treasuries can be considered risk-free. Some big corporate names already offer lower credit risk than the US government, although that does not mean that they should be regarded as safe havens.

In Europe, the credit worthiness of periphery countries is being dramatically questioned by markets and interest rate risk has become credit risk. The Italian government bond market has been a very good safe asset up until recently, he said, as it was negatively correlated with the stock market. Now, with the sovereign debt crisis, the correlation has become positive, so investors are taking the some kind of risk, which is country risk.

"The best way to adapt to this world is to think that every asset class should be modeled and considered, from an investment point of view, as a risky asset, with its own risk profile and also in the relation with that of other assets," said Mr. Lombardo.



This new financial crisis also poses big challenges for managing risk. As the spread of future scenarios is very broad, it is not possible to hedge portfolios against all risks. Today, both a deflationary and inflationary scenario seem plausible. If the immediate environment is deflationary, in the future an inflationary situation is a high probability considering exploding public debts. Investors

should try to decide which risks they want to hedge, should be flexible, and adapt their approach over time.

But most probably, having identified the risk, it is then that the insurance becomes the most expensive. "In practice, the best moment to buy protection from volatility was when nobody wanted protection," said Mr. Lombardo.

Fashionable hedges have recently come under discussion, such as the Swiss franc, following SNB's intervention to control further currency appreciation. "A fantastic hedge can be manipulated and can be very crowded, so you have to always use your fundamental judgment. If everybody is rushing to find the new Swiss franc, such as the Nordic currencies, these hedges can become very crowded and become risky."

The astounding gains in government bond markets come as a surprise, given they are the source of the market's problems. Investors have been willing to ignore any inflation or default threat and accept tiny yields just to hold what they believe to be safe haven assets, says Thomas Becket, CIO of Psigma Investment Management. This course of strategy is wrong for the medium-term, as ultimately the riskiest assets could be government bonds, also given the risk of a "massive inflationary problems" in the future.

Short duration government bonds in Asia are an exception. Singapore is probably "the Swiss land" for the rest of the decade. "Singapore is a pretty safe haven asset and it could be a bastion of strengths in a world where there isn't much strength going forward," says Mr. Becket.