Investing Through Inflation

How the Fed is Forcing Investors to Take More Risk

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Investing Through Inflation

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How the Fed is Forcing Investors to Take More Risk

Summary: *Since the Great Financial Crisis short term interest rates have been controlled by central banks. Their objective has been to spur economic activity. Investors need to realize that these interest rates also serve to set market risk. If rates are artificially low, risk is artificially low. When risk resets asset prices will reset also – lower.*

Regrettably, I've never done acid. I say regrettably because I have a notion that a good acid trip would be the one time my conscious mind would be freed from the omnipresent calculation of risk vs. reward. Micro decisions every hour of every day. I've wondered what it would be like to be momentarily released from the burden. Yet our existence depends on the constant analysis of risk vs. reward. Usually the decisions are trivial, with obvious outcomes, but not always. Everybody has their own risk level. Your risk profile will be different than mine. We self-determine our risk. Personal risk isn't calibrated to a benchmark standard.

In the investing world risk is calibrated. The models we rely on require it. It's quaintly called the Risk Free Rate of return (RFR). It's the theoretical return on an investment with zero risk. For my entire investment career that has been the US 3-month t-bill. That is, until the Great Financial Crisis, thirteen years ago. More than half a generation ago. We've all but forgotten the heroic initiatives undertaken by Henry Paulson (Secretary of the Treasury), Ben Bernanke (Chair of the Federal Reserve) and Timothy Geithner (President of the Federal Reserve Bank of New York) to right the ship of the sinking global economy. What it took was setting the Risk Free Rate of return to nearly zero[1].

Essentially the RFR is the cost of money. It's the single most important price in the world. It was set at near zero and stayed at near zero for over seven years. Refer back to my earlier definition – the rate of return on an investment with zero risk was – zero. What do you think that does to one's sense of risk vs. reward? It forces you to reach for more reward by taking more risk. And so we have.

An investor builds an investment risk framework starting with the RFR. By taking more risk an investor would expect more return. Presuming nobody's happy with zero one steps out the risk curve. A six-month t-

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[1] Technically the Federal Reserve sets the Fed Funds rate, i.e. the rate banks charge each other. But that rate influences the 3 month t-bill rate, the one I identified as the RFR.

bill should have a higher return than a 3-month t-bill. Longer term, more risk, higher reward. Likewise, a one-year bond should be higher than a 6-month bond. And onwards for 3 years, 7 years, 30 years. Maybe you like the 7-year term but not the interest rate. Well, investment grade corporate bonds pay more than government bonds. High yield bonds pay more than investment grade bonds. Private bonds might pay more than tradeable bonds albeit with less liquidity. Equities offer higher returns but are riskier than bonds. Growth stocks riskier than blue chips. Emerging markets vs. developed markets. And so on.

A well constructed investment portfolio is a blend of assets with varying risk/reward characteristics that average out to match an investor's risk/reward appetite. If you're targeting an overall 6% percent return you'll take some 3% expected return allocations with safety of principal and some 9% returns with higher risk and over time be happy with a blended 6%. That's the theory.

Here's the million dollar question. What if the base rate, the Risk Free Rate, is set too low? What if the Federal Reserve, for whatever reason, kept the RFR lower than natural market forces would have allowed? Wouldn't that make an investor pause and ponder if perhaps the risk of one's portfolio is understated and that one's reach for rewards is perhaps taking on more risk than the models or your investment advisor is suggesting? It's a leading question. I say YES, the investment industry, by and large, is saying Nah.

I started this article by cautioning that we can't suspend our instinctive notion of risk/reward. We individually determine our personal risk/reward framework constantly adjusting and calibrating it so we can live our lives. I'm cautioning investors to do the same with their portfolios. Question the validity of the risk/reward that the marketplace is implicitly stating. Calibrate your investment decisions and portfolios by questioning the validity of the Risk Free Rate and the risk/reward framework bootstrapped from that base. A variable as important as the Cost of Money can't be controlled by an agency (Federal Reserve) perpetually. When natural market forces prevail again risk premium will adjust upwards and asset prices will reset lower. Be ahead of that. Oh, and with regards to my opening statement – Don't Take Drugs.

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