

## COMMENT

## MODEL BEHAVIOUR? | Unexpected events can render investment models futile

**J**UST OVER A YEAR HAS PASSED SINCE THE EVENT that first brought the sub-prime crisis to public attention: a surprise announcement from HSBC that its US operation had lost \$10bn (£5.1bn) in this area. With hindsight, that's a modest amount. Since then, in a huge destruction of capital, major financial institutions have written off \$120bn, and it is likely that there is more to come.

Central banks are now cutting interest rates to minimise the impact of the crisis, with the Federal Reserve leading the way. Following the two-stage cut in January to 3 per cent, there is a high probability that there will be a further reduction of 0.5 per cent in March. It is quite possible that US rates will fall below 2 per cent during the year – a level not seen since 2004.

It is in such times of instability that the flawed nature of some financial models is highlighted. In an attempt to achieve certainty, sophisticated mathematical techniques have been used to calculate both expected returns and risk. The assumption is that past returns – and, more importantly, correlations between assets – are a strong indicator for the future. As the sub-prime contagion has spread, these assumptions have proved to be hopelessly optimistic. The damage has been done because an overreliance on these models encouraged investors – and, in particular, certain banks – to overcommit themselves. Hence the painful unwinding that we are seeing at the moment.

In recent years, many private banks and private client investment managers have become increasingly reliant on models in an attempt to assess and document their clients' investment objectives and attitude to risk. These models also make assumptions based on past returns and correlations between asset classes to formulate an investment strategy designed to meet their clients' objectives. However, in times of stress, there is evidence that past relationships break down and, as a result, the diversification benefits predicted will end up being overestimated. In the event of poor returns, the adviser can, of course, use the output of the model to deflect criticism.

A far better approach is for experienced investment managers to make sensible judgements based on the available information and to be given the flexibility to adapt quickly to changing circumstances. Good investments get dragged down as much as bad ones when confidence is low and there are plenty of opportunities for those prepared to do the necessary research. When we come to look back at 2008, it is likely that a number of the current preconceptions and assumptions will have been severely tested. Models are for the obedience of fools and the guidance of the wise.



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