Strategic Investment Group®

2017 Idea Lab Highlights

This year's Strategic Investment Group's annual conference, the Idea Lab, brought together investment professionals and academics to consider a broad range of issues central to managing portfolios in the challenging environment of compressed risk premiums, high levels of policy uncertainty, and low market volatility. While it is impossible to do justice to the breadth and depth of the discussions during the two-day forum, four areas were particularly noteworthy: the risks lurking in current market dynamics, the private equity capital glut, the dynamics of the leverage cycle, and the insights of the Idea Lab's keynote speaker, Professor Steven D. Levitt, co-author of the best-selling Freakonomics series.

Cyclical Positives; Lurking Vulnerabilities

The Strategic team set the stage with a review of the market outlook, noting that global equity markets have been on a tear this year. Expectations for sustained global economic growth, a stronger-than-expected outlook for the Chinese and European economies, rising corporate earnings, low inflation, and continued easy financial conditions have been the main drivers of the rally. While the cyclical outlook appears favorable, there remain lingering vulnerabilities. Productivity gains in advanced economies have been disappointing and rising income inequality has contributed to populist and protectionist sentiment. Highly accommodative policies have suppressed asset price volatility, contributed to a search for yield that has distorted asset pricing, and fueled rising debt levels in advanced and emerging economies. A shift to tighter financial conditions in the wake, for example of a faster than expected reduction in monetary accommodation by the Fed, could call into question asset valuations buoyed by the frenetic search for yield.

Private Equity Awash with Capital

One area where the search for yield appears particularly pronounced is the private equity market, which is displaying signs of hubris. Strategic's private equity team reported that fundraising for new private equity funds is on pace to reach its highest level since 2007, just before the great financial crisis. This surge of new capital coupled with a scarcity of deals has led to record levels of dry powder. As a result, private companies are being priced to perfection with new deals being concluded at record high multiples. Fund sizes are increasing, established managers are introducing new bolt-on strategies, new and untried players are entering the market, fund terms are becoming less investor friendly, and due diligence periods are being compressed. In these circumstances, Strategic has been taking a cautious approach to new commitments, favoring partners with an established track record of discipline and a focus on value.

Credit Surfaces and the Levarge Cycle

Professor John Geanakoplos, James Tobin Professor of Economics at Yale, discussed the leverage cycle and the use of credit surfaces to provide a more precise view of credit conditions across market segments. When leverage is high, households and investors can buy assets with little money down regardless of their creditworthiness. When low, many buyers may need cash to buy assets and even the most creditworthy find it difficult to borrow. In the upswing, strong fundamentals and low volatility encourage borrowing and loosen credit standards fueling asset prices. In the downward spiral, leverage reaches its limit and lending standards tighten, triggering a fall in asset prices. At the cycle's nadir, forced liquidations send assets plummeting. The axe falls hardest on those who had been the most optimistic and overextended. According to Professor Geanakoplos, credit conditions are best captured by a surface that sets the offered interest rate from lenders as a function of the amount of collateral needed to borrow and the creditworthiness of the borrower. Using these variables, the credit surface captures the impatience of borrowers and their optimism for the future as well as lenders' fear of default. By combining different indicators for collateral and creditworthiness, credit surfaces can be constructed for the mortgage and corporate bond markets, giving a more precise and nuanced view of credit conditions across the economy than merely focusing on interest rates.

The Wisdom of Freaks

A highlight of the 2017 Idea Lab was Professor Levitt's keynote speech delivered at the top of the historic Hay Adams Hotel, overlooking the White House. Professor Levitt urged us to cherish ideas and think critically about the world, cautioning that conventional wisdom blinds us to simple, yet powerful ideas. Using a series of vignettes, Professor Levitt revealed how ideas can hide in plain sight. Once we break through the fog of conventional thinking, these ideas appear disarmingly simple and obvious yet represent valuable insights. Levitt cited, for example, the case of the disappearing dependents triggered by a simple innovation initiated by John Szilagyi, a 30-year veteran with the IRS. Szilagyi argued that by requiring taxpayers to provide the social security number of each dependent, not just the dependent's name, spurious claims could be reduced. In 1987, when Szilagyi's idea was put in place, millions of dependents disappeared. Levitt pointed out that this one simple idea has generated $20 billion in additional tax revenue, illustrating the power of thinking like a freak.

This year's Idea Lab is yet another example of Strategic's commitment to remain a pioneer and thought leader of the Outsourced CIO industry, 30 years after its founding.

1001 Nineteenth Street North, 16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com