36 South views by Richard "Jerry" Haworth

Time will tell

*"A **universal three-way trade-off** constrains adaptive strategies throughout the tree of life, with extreme strategies facilitating the survival of genes via: (C), the survival of the individual using traits that maximise resource **acquisition** and resource control in consistently productive niches, (S), individual survival via the **maintenance** of metabolic performance in variable and unproductive niches, or (R), rapid gene propagation via rapid completion of the lifecycle and **regeneration** of niches where events are frequently lethal to the individual."* [1]

We have often alluded to the similarity between thrival and survival in nature and in portfolio management. An interesting thought meme is Universal Adaptive Strategy Theory (UAST), a theory that states that ALL organisms in the world thrive by maximising the trade-off between three primary functions: acquisition, maintenance and regeneration. Now call me insane but doesn't that sound a bit like return, risk and correlation? Let me look at possible parallels with the extract from Grime & Pierce's book.

Organisms aim to "maximise resource acquisition". In portfolio management we do it by returns or increasing asset size. Getting away from zero, i.e. growing assets, is a good way to minimise the probability of getting back there.

Organisms aim to minimise the cost of maintenance and maximise resource control. Risk management does exactly that "[i]n consistently productive niches [...]". You've got to have an investment edge or alpha.

What about "individual survival via the maintenance of metabolic performance in variable and unproductive niches […]"? When your individual assets are under stress, they must have resilient traits that allow them to weather whatever storms arise: "rapid gene propagation via rapid completion of the life cycle in niches where events are frequently lethal to the individual". Basically this means that there must be a mechanism for some of the population to survive any event. A short life cycle is one way. Having multiple organisms occupying different niches with different traits is another. In other words: being uncorrelated to each other.

Dinosaurs and portfolio managers in 2008 are probably good examples of organisms which were too correlated for the event they faced!

This is all interesting but we think the meat of this analogy is the "three way trade-off". You can't get one without the giving up some of the other. The current market environment with low interest rates has focussed everyone's attention on "resource acquisition" or return at the EXPENSE OF both risk and correlation. Now because we use volatility as a proxy for risk and because volatility is low,

[1] Grime, J.P. and Pierce, S. (2012) Evolutionary Strategies that Shape Ecosystems, Chichester, West Sussex, UK; Hoboken, NJ: Wiley-Blackwell; p. xiv

we think that risk is low. Absence of evidence is not evidence of absence. In addition, portfolio managers have been corralled into highly correlated investments by central bank action.

Is it the correct adaptive strategy for the current market environment? Or should we heed the words etched into the temple of Apollo at Delphi that could be translated as ‘nothing in excess’ or alternatively ‘everything in moderation’ and balance the portfolio by trading off some of the return in exchange for risk and correlation benefits?

Time will tell…