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The Numerator Effect

THE LEAD | February 15, 2023

Over the past twelve months, as Fed rate hikes have taken hold, much attention has been paid to the denominator effect. This is the impact on investors' portfolios as liquid asset prices have fallen, creating larger-than-anticipated allocations in other areas.

For many the over-sized shares are coming in alternatives. Institutional investors set limits based on policy and risk considerations. Exceeding them, particularly with illiquids, creates challenges not easy to address. Selling non-traded assets or buying more volatile publics whose values could drop further are not great options.

Not enough discussion, in our opinion, is taking place around the numerator effect. No one questions that equities and bonds will eventually recover their values as interest rates settle down and recession worries fade. Indeed January 2023 was the top month for IG bonds since 1975 and stocks had among their best openings in over two decades.

While one month does not a trend make and last month's labor data dashed hopes for rate softening anytime soon, we like to think in strategic terms. The whole point of adding alternatives as part of a well-diversified portfolio is providing balance and cushion in the face of price volatility.

The fact that portfolios are enduring short-term over-weighting is the glass-half-empty view. Having at least some exposure last year to private credit, private equity, real assets, and the like, should have helped offset the deeply negative returns experienced in the 60/40 world.

The denominator effect is also cited by private asset investors as one reason they are hesitant to add to illiquid positions. If you're not weighted above, say, a 15% alts allocation, why risk going over 20% with further denominator erosion? Yet doing so, for example, with private credit today could also result in outsized returns with lower risk and better structures.

The DE also involves a time element. Liquid asset values react immediately to market moves. Alts are priced on fundamentals so move slowly, if at all, relative to macro economic concerns. Over long periods and through business cycles one expects allocation weighting to even out. In the meantime the benefits of private credit continue to accrue to investors.

Those virtues are moving some public pension funds who are over their limits to institute waivers allowing for modestly expanded private credit baskets. Unlike the traditional 60/40 mix, PC holds it value over time. When conditions normalize, the improved yields and valuations can be effective counterweights for the temporary allocation imbalance.