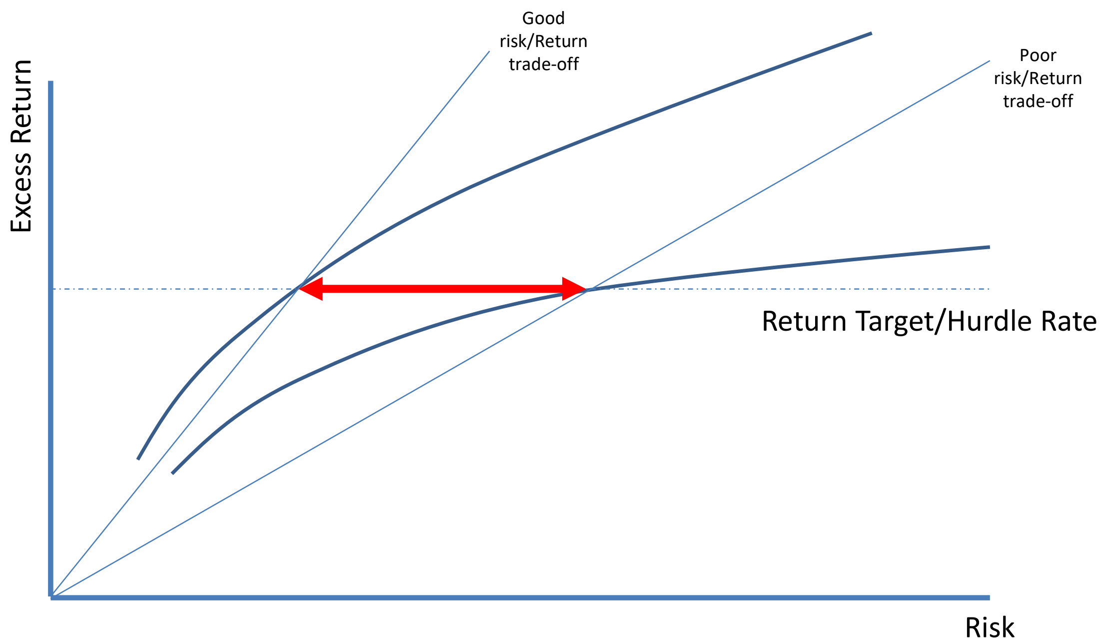
# Follow the herd with hurdle rates and risk getting hurt?

If you will forgive the tongue twister, I want to outline a key shortcoming in how many investors approach investing. When constructing a portfolio, either within an asset class (for example, a fixed income manager) or at a whole of fund level, it is common for investors to adopt a hurdle rate approach. That is, they focus on constructing a portfolio that minimises risk for a given target return or for excess returns. As shown in figure 1, they pick the point on the so-called 'efficient frontier' that offers their target level of return at the lowest risk.

**Figure 1: Return Targeting Results in Taking the Most Risk at the Wrong Time**




This is fine in an academic model where the world is static, but not in the real world. In the real world, risk/return trade-offs are always changing and, implicitly, the efficient frontier is always moving. Take for example a fixed income manager always aiming for 2% of excess return, this targeted approach would mean:

- When risk return trade-offs are favourable (for example, in a wide credit spread environment) you could achieve the 2% return hurdle with a low risk (i.e. high credit quality) portfolio.
- When risk return trade-offs are not particularly favourable (when spreads are low) to achieve the same return you need to take much more risk – that is purchase a much lower credit quality portfolio.

Inherently this involves taking more risk at exactly the worst time. While this dynamic is most transparent in the world of fixed income – where credit spreads provide a signal of risk return trade-offs – it applies more generally. Return targeting, be it within a single sector or across asset classes, runs the risk of significant implicit shifts in risk…..and this can hurt in a dynamic world.