

ASSET ALLOCATION: PanAgora's new model shifts to bonds

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NEW YORK -- The Federal Reserve's shift to a tightening mode is prompting PanAgora Asset Management to switch the emphasis from stocks to bonds in its tactical asset allocation program, says Ed Peters, director of the model-based program.

"We are shifting toward an under-weighting in equities and an overweighting in bonds in coming months. Because if the Fed is going to get rid of inflation, that's good for bonds," Peters tells Quick Nikkei News.

As for stocks, he says, they will face two escalating dangers: not only earnings disappointments, but also a rise in market volatility due to uncertainty about Fed tightening and whether the economy ultimately will go into a soft landing.

"Don't fight the Fed" is a truism throughout the investment world. Many of Wall Street's most influential strategists, anticipating that the central bank was poised to raise the federal funds rate as it finally did Tuesday, recommended switching a portion of assets from stocks to bonds earlier this year. Indeed, Peters is one of very few money managers who will admit to making changes in reaction to, rather than ahead of, the widely expected Fed announcement.

His move was dictated not by personal judgment, but by a redesigned asset allocation model that PanAgora began using in January. Compared with the model the Boston-based firm had long used, the new version assigns a far more explicit role to Fed policy.

PanAgora's new model looks at the market in dramatically different ways, depending on whether the Fed's latest rate move has been a tightening or an easing. "It's almost like having two models," Peters says. "The complexion of the model changes from one regime to the other."

Bimodal model keyed to Fed policy

"Federal Reserve policy determines what kind of environment the markets are going to be in," says PanAgora's Peters.

When the Fed is easing, the stock market tends to focus on companies' long-term growth prospects in an expanding economy, he says. When the Fed tightens, the ultimate result will be either a soft landing or a recession. "The uncertainty between the two outcomes causes a big increase in volatility" in the stock market, Peters says.

Investors become focused on the short term. "People begin to look at information as it's released, and they interpret it one way in the morning and another way in the afternoon," he says.

"It's this change in psychology, (which occurs) when the Fed is raising rates rather than cutting them, that really has the big impact on the markets and on our model."

PanAgora's tactical allocation model tells the firm how to divvy up its portfolios among stocks, bonds and cash. The model's inputs fall into three broad groups: value-related measures such as earnings and long-term bond yields; business cycle and monetary indicators; and short-term technical indicators, such as market volatility.

When the Fed's last action was an ease, the model considers only value factors and business cycle factors; technicals are ignored. When the Fed moves to a tightening mode, as it did Tuesday, the factor weights switch to 50% value, 20% business cycle and 30% technical.

Until Tuesday, Peters says the model called for slightly overweighting stocks, underweighting bonds and overweighting cash. Now, he says assets are being shifted more toward bonds and away from stocks. Rising interest rates would further tilt the model against stocks, he adds.