Perception versus Reality: Managing Risk
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While we spend time analyzing each of our individual positions and holdings, when it comes to portfolio management, the whole is very much more than simply the sum of its parts (Harry Markowitz won a Nobel Prize in 1990 for this insight). By definition, a well-diversified portfolio of assets (i.e., a portfolio of investments that do not all move together in the same direction) will contain some laggards during any given measurement period, particularly over shorter-term periods. But it’s at least as important to focus on the overall portfolio and how the pieces fit together and complement one another —how they are performing relative to each other and whether that performance is consistent with the original rationale for owning them.

Successfully managing portfolios also requires the discipline to resist trading based on emotion (fear and greed), rather than on long-term return drivers such as valuations, yield, and earnings growth. Even in an advanced economy like the United States, the stock market has had at least a 10% decline every 16 months on average since 1950. Bear markets (20% or greater declines) in the United States have happened about every seven years, on average. The catch is that in most cases you can’t predict what the exact cause of the volatility will be or exactly when it will hit. Even if you did successfully call the bear market, you’d need to also successfully time your re-entry so as not to miss out on the subsequent gains. And you’d need to do this consistently and repeatedly over an investment lifetime. That is simply not realistic, which is why our tactical investment approach is based on a range of potential outcomes and a longer-term time frame. As the examples we discuss below illustrate, in our view, making investment decisions based on short-term market forecasts (guesses) is a losing game. We have no confidence that this approach can be executed successfully over time.

THE BREXIT VOTE

In the run-up to the vote, polls suggested the outcome could be close but would most likely result in the United Kingdom remaining in the European Union. Financial markets were clearly surprised by the opposite result. Global stocks sold off in the two days following the vote. The Vanguard 500 dropped 5.3%, emerging-market stocks fell 6.7%, and European stocks plunged 13.6%. In contrast, the core bond index gained more than 1%.

In the vote’s immediate aftermath and after careful consideration, we decided not to make any changes to our portfolios. We were actively inactive. We believed the vote increased the nearer-term risk of recession in the United Kingdom and Europe, and potentially globally. We also acknowledged the potential for increased shorter-term downside risk in our European stocks tactical position in particular. But in our assessment, Brexit did not materially impact our longer-term five-year outlook and assumptions for European corporate earnings growth and valuations. Therefore, we held our positions at a time when many investors were fleeing to traditional safe-haven assets. That decision proved beneficial for our portfolios’ performance in the third quarter, as European stocks rebounded 14% from their Brexit low while core bonds gained just 0.5% over the same period.

THE U.S. PRESIDENTIAL ELECTION

Each time a U.S. presidential election approaches, we get questions from clients about our view and the impact on our investment outlook and portfolio positioning. Given the atypical background and behavior of the Republican nominee, we are being asked about the election even more than usual this year. Here is a quick review of how we think about elections in general within the context of our overall
investment approach. (See our recent article “How Much Do Elections Matter?”)

While the specific circumstances of any given election are always unique, our approach remains the same. First, to the extent a particular result is widely expected, current asset prices will reflect the market consensus. In order for us to believe there is a tactical investment opportunity stemming from a particular election outcome, we’d need to believe (1) we have an edge in assessing the outcome better than the market does and (2) our view would have to be materially different from the consensus.

There is too much uncertainty and too many “non-election” variables that impact investment outcomes for us to likely see any value in positioning our portfolio for a particular result. Even if we had a higher degree of certainty as to both the outcome and the policies that would be implemented, the ultimate economic effects and outcomes would still be highly uncertain. Macroeconomics is far from a hard science, and there are a multitude of other factors and variables that impact economic and financial market outcomes beyond U.S. fiscal and monetary policy.

In sum: (1) we are not willing to bet on a particular election result relative to the “odds” already embedded in current market prices, (2) there is a wide range of potential macro outcomes around either result, and (3) there are a multitude of other variables and factors unrelated to the election results and out of U.S. politicians’ control that are likely to have at least as meaningful an impact on the course of the global economy and financial markets over the next five years.

Instead of betting on election results, we stick to our longer-term analytical framework, in which we consider and weigh multiple macro scenarios, and assess the potential risks and returns for numerous asset classes and investments in each scenario. As investors, we expect to experience market price volatility and shorter-term downside risk at times (the degree will depend on the client’s risk tolerance and the corresponding risk exposure of the portfolio). Stock market history makes this clear. Volatility comes with the territory in stocks and other “risk assets.” They wouldn’t be considered risky otherwise!

CENTRAL BANKS AND MARKET DISTORTIONS

Lastly, global central banks have been a driver of significant market distortion in recent years. Along with the U.S. presidential election, their policies, particularly the Fed’s, remain a key near-term wildcard for financial markets. At its last meeting on September 21, the Fed remained on hold but signaled it is on course to raise the federal funds rate later this year, likely at the December meeting. (We’ve heard this story before.) The Fed also lowered its longer-term forecast of interest rate hikes yet again. It now forecasts just two rate hikes in 2017, down from the three hikes forecasted at the June meeting and the four hikes forecasted at the March meeting. Bond and stock markets responded positively.
Median Trailing P/E of Utility Stocks


Low-Volatility Stock Valuations Near Record High

Source: S&P Capital IQ Compustat, as of 8/31/16.

The distortionary effects of these extraordinary central bank policies can be seen as investors are effectively being forced out of low-risk, but extremely low-yielding, core bonds into riskier assets that offer higher current yields (still quite low compared to historical levels). For instance, the traditionally “defensive” yield-oriented sectors of the stock market, such as utilities, telecoms, consumer staples, and REITs, are areas where many investors appear to be “reaching for yield” as well as perceived safety, but where we and many of our active fund managers actually see significant risk. As bond yields have been depressed, money has flooded into these sectors and related “low-volatility” ETFs. As a result, their valuations have soared. Strong short-term performance has attracted more money, perpetuating the cycle. Ironically, the perception that these are low-risk investments and appropriate “bond-like” substitutes for true fixed-income exposure has made them much riskier due to their high valuations and what looks a lot like speculative short-term money flows rushing into these stocks and ETFs.

But these trades can unwind quickly and the momentum can work in reverse. Market history is replete with examples of investors getting burned by ignoring valuation, reaching for yield, and chasing recent performance. Because investors view these sectors as bond substitutes and a play on continued depressed bond yields, one clear catalyst for a reversal would be a rise in rates.

These sectors’ performance in August and early September shows they may be riskier than they seem to be. While the overall stock market was flat in August, the utilities and telecom sectors fell roughly 6% and low-volatility ETFs lost around 2%. Then, on September 9, when a previously dovish Fed governor shocked the markets by indicating he was inclined to raise rates at the next Federal Open Market Committee (FOMC) meeting, the Vanguard 500 dropped 2.5%, while utilities and REITs fell nearly 4%. Low-volatility stocks were anything but; they fell 3%. Core bonds dropped about 0.5% on the day.

It certainly seems that these “defensive” plays are vulnerable to any hint of interest rate increases (let alone actual rate hikes) and are potentially higher-risk right now than even the broad stock market, not to mention bonds.

Many of our bottom-up active fund managers are avoiding these currently popular areas of the market. One recently wrote,

Oddly enough [the lower-risk names in his portfolio] are not the traditionally “safe” sectors such as bonds and consumer staples stocks—as they have been bid to the moon by Wall Street’s latest
Another stated,

We are seeing risk in areas where other people feel safe or feel secure. . . . In the stock market, the most obvious one is how safe people feel with high dividend yield stocks. People are paying an extreme premium for short-term yield. (emphasis added)

Yet another wrote,

We believe the aggressive monetary stimulus measures which have driven fixed income yields to unprecedented levels have created market anomalies which are unlikely to persist. . . . In a market where perceived safety and dividend yielding stocks have been bid up to exceptional levels (arguably making them neither safe nor high yielding), many other stocks appear mispriced. (emphasis added)

While it is not clear that low-volatility and dividend stocks are truly going to be lower risk going forward (e.g., if or when interest rates rise), to the extent the “buy ‘bond-like’ and dividend-yield stocks” theme remains in play, it will likely be a headwind for our actively managed U.S. stock funds overall. But when that trend reverses, our managers and portfolios should benefit. We saw that happen in the third quarter, as the yield on the 10-year Treasury bottomed at 1.37% on July 5 and closed the quarter at 1.56%.

While ultralow interest rates are supportive of financial asset prices (many would say distortive as well), we continue to view them as unsustainable and inconsistent with longer-term economic growth. Trying to anticipate the markets’ reactions to each Fed governor utterance or FOMC policy statement is a short-term guessing game that we simply won’t play with our investment portfolios.

**Putting It All Together**

Our decision-making is anchored in our long-term fundamental and valuation-driven approach. Given our approach, we and our clients need to be psychologically and financially prepared for periods of market stress and able to ride them out on the path to achieving our long-term investment and financial goals. Investors who can’t stomach a given level of volatility or downside risk should reallocate into a portfolio with a lower targeted risk level. And the time to do that is before a period of volatility strikes, not during or right after it when they would be selling their riskier assets at lower prices and buying more defensive or safer assets at higher prices.

We structure our balanced portfolios across a well-diversified mix of investments, each with a distinct role to play within the overall portfolio (e.g., return-generation, risk-reduction, and hybrid/alternative). We expect our portfolios to be resilient and to perform at least reasonably well across a wide range of outcomes, balancing our objective of long-term capital appreciation with shorter-term downside risk management appropriate for each client’s risk tolerance.

**Closing Comments**
While July and August were unusually calm months for the markets, volatility picked up in early September. We’re prepared for more of it heading into (and potentially coming out of) the November election, as well as market swings related to the increased likelihood of a Fed rate hike in December.

In addition to our tactical positioning and portfolio tilts, we remain diversified across multiple asset classes and strategies with diverse risk exposures and return drivers. This diversification should smooth out the overall portfolio ride over time. Finally, we remain alert to new investment opportunities as well as new risks we will need to manage against.

—Litman Gregory Research Team (10/5/16)

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