portfolio construction forum

Challenges in building portfolios today (and what to do)

Dominic McCormick | Select Investment Partners | 09 June 2016

The current investment environment is arguably one of the toughest ever in which to build portfolios and be confident they'll deliver reasonable returns and be robust into the future. This is particularly the case if anchored only to conventional portfolios that have worked well in the past but which face increasing headwinds.

There are a range of approaches that can be taken which we'll discuss below.

Firstly, however, what are the major investment challenges?

1. **The extremely low returns on safe assets** (cash/term deposits/bonds) which is making building more defensive portfolios that offer acceptable returns and risk particularly difficult. As an indicator of this, currently almost two thirds of the developed market government securities market is offering yields of less than 1%.
2. **The expensive valuation level of many mainstream risk assets** (shares, property), especially in an environment of low expected economic/earnings growth which implies low future long-term returns and greater risk of significant short- to medium-term capital drawdowns. The US sharemarket, for example, is currently trading at a trailing GAAP PE of over 24 - a level seen only a few times in history and which each time preceded a major bear market.
3. **The dominant but unpredictable (although possibly waning) influence of central banks on asset price behaviour** which is making short-medium term asset allocation extremely difficult. Dynamic Asset Allocation (DAA) heavily relies on absolute and relative valuations but is adding little value in this volatile "risk on/risk off" environment.
4. **The high level of private and government debt worldwide** and the continuation of monetary and government policies that keep growing this debt, making both the economic and financial market outlook fragile. Australia is not immune here, particularly given its world beating levels of household debt and uncertainty as to how this debt build-up is resolved.
5. **Growing political and geopolitical risks** as extreme parties/candidates gain increased popularity and economic and military tensions between major powers grow. This is not just the risk of Donald Trump as US president or Brexit, but the impact of widespread political polarisation and growing nationalism and protectionism.

These challenges suggest that future returns from conventional portfolios are likely to be poor and the risks of sharp capital drawdowns are growing.

Some basic modelling by John Hussmann of Hussmann Funds based on starting valuations and reasonable expectations looking forward suggests that:

> "The prospective return on a conventional 60%, 30%, 10% mix of stocks, Treasury bonds, and T-bills has been driven to the lowest level in history outside of March 2000, January to March 1937, January to September 1929, and a momentary episode in March to May 1930."

These all preceded periods of very poor returns. While this is from a US investor perspective, Australia is not immune from these pressures.

A common theme running through the above challenges is the role of central bank policies and record low interest rates. Even the growing political dysfunction in countries is at least partly caused by inequality exacerbated by years of easy monetary policy as asset prices (held mainly by the rich) have marched higher. Further, growing tensions between major countries increasingly reflects competitive pressures to ease monetary policy to lower currencies to lift economic growth levels.

For investors, the challenge was well described by hedge fund Passport Capital in their March 2016 quarterly report:

> "Informed of the likely future economic growth path one has trouble taking risk, yet betting against desperate policymakers now leaves one almost equally irresponsible. Unlike predicting secular changes in industries or evaluating the merits of corporate decision-making, logic and research don't work as well for predicting action of government officials, particularly if you don't trust their models."

Another striking comment was made in an article by Pascal Blanque of Amundi Asset Management and Amin Rajin of Create Research, *"Markets yearn for their central bank sugar daddy" FT 2 May 2016*:

> "Most likely, ultra-low rates will remain a fact of life for the foreseeable future, with no return to a scenario in which asset prices mostly reflect their intrinsic worth."

Think about the implications of this statement, if true.

It is suggesting that the fundamental, valuation-based approach of the vast majority of the active investment industry is impotent, for now at least. No wonder so much money is moving into passive investments.

It suggests that in a world of policy influenced and controlled markets, the only valuable members of an active investment team are those that have special insights into what central bankers and other policy makers are thinking. The rest of the investment team may as well go on extended leave.

Fortunately, I doubt that the present situation can continue too much longer and there are already signs that the power and influence of central banks is fading. These include unexpected economic and financial market responses to new monetary policy measures, increasing instances of chaotic currency moves, and the recent move higher for gold prices.

Having said this, central banks and policy makers are desperate to keep things going and their power intact, so are likely to keep trying new things. Perhaps their extreme influence could last longer than many expect.

So, how can investors build portfolios in this environment? There are a number of options.

1. **Stick to conventional, fully-invested, SAA-driven portfolios.** This is the "relative value", long-only approach, investing almost exclusively in mainstream assets. It's adopted by most of the investment industry. While there are variations on this approach, including using lower cost passive or smart beta funds in the portfolio, the problem (as mentioned above) is poor prospective medium-long term returns given current valuations of mainstream asset classes (compounded by the fact that benchmark indices tend to be skewed towards the more expensive areas). This approach could experience a particularly rough ride in a major bear market environment. However, if investors are prepared for lower returns and a roller-coaster ride, many may well prefer to stay with this approach as it has certainly delivered good results over many years. However, I suspect this is a poor time for new investors to be investing in such portfolios, although reasonable returns could well continue in the short term while markets positively respond to the current environment.

2. **Throw caution to the wind and participate more fully in the central bank driven bubble in many asset valuations.** If central banks are contributing to higher asset prices and even bubbles, why not aim to more directly benefit from this, at least while it lasts? This involves investing in assets benefiting most from loose monetary policies and record low interest rates, irrespective of valuation - primarily, shares and property. It may even involve taking advantage of record low interest rates to gear into such investments. Any market setbacks should be seen as buying opportunities on the expectation central banks will once again come to the rescue. Of course, this can't last for ever so the aim would be to try and exit or reduce risk before it all unwinds, although timing this will not be easy. This portfolio approach will probably do quite well until it does spectacularly badly. It is not for the feint hearted or inexperienced investor.

3. **Build an "alpha only" portfolio.** This portfolio approach relies almost exclusively on managers' (or the individual investor's) skill to add value in ways that do not rely on the market needing to move higher (beta). This involves focusing on identifying managers who were good at areas such as trading, market neutral and long short equity investing, relative value/arbitrage and global macro. Of course, this is easier said than done. As we have noted above, making money in many of these areas has been difficult in the current environment, particularly after high fees, and as demonstrated by the poor recent performance of hedge funds generally. The "alpha only" portfolio therefore comes with no guarantees of meeting return objectives and would almost certainly lag if markets surge higher.

4. **Build an absolute/real return diversified portfolio**. This is a more truly diversified portfolio exposed to a variety of areas and risks, but with an emphasis on downside protection. One approach is building a "barbell" portfolio with a mix of cash, hedges and protective assets/strategies on the one hand, and higher risk and opportunistic investments on the other, both surrounding a larger core exposure to lower risk growth assets and strategies. It would incorporate some of the same alpha alternatives in the approach above but would also contain more alternative assets and opportunistic positions (private equity, gold exposure, inflation-linked bonds, etc) and be more contrarian and active from a DAA perspective (notwithstanding the challenges for DAA in the current environment). Placing a component in well selected and less liquid/illiquid assets may also be a (small) part of this approach. Such a portfolio should be robust in a range of environments and may even benefit from a disorderly unwind of the current environment. However, it would most likely lag in a continued bull market for mainstream assets.

5. **Adopt a disciplined, long only "value" portfolio.** This approach involves the discipline of investing only in assets that are currently cheaply valued and therefore offer attractive prospective long-term returns and a high "margin of safety". Followers of Warren Buffett or the father of value investing, Ben Graham, tend to be in this camp. The rationale is clearly sensible and this approach has tended to deliver attractive long-term returns. However, the challenge in the current environment is that a true value/contrarian approach may struggle to come up with sufficient investment ideas to fill a portfolio. If this is the case, investors could become frustrated about being left predominantly in low returning cash, particularly if markets are still rising.

6. **Give up and simply stay in low returning cash, term deposits and short-term bonds**. This approach is perhaps a reaction to the pressures of the value approach in the current environment and involves doing little until the world returns to some sort of normality and better investment opportunities emerge more generally. However, who knows when this will occur? Some investors believe they are taking this approach by investing in the "safety" of property but I would argue that this is much the same as approach two, riding the central bank bubble.

I don't pretend that all the possible investment options have been covered here. However, most approaches can fit into these six broad categories. In practice, many portfolios will contain elements of more than one of these approaches, with varying levels of emphasis and complexity.

Much will depend on where the investor is comfortable to sit on the spectrum from conventional, SAA, passive portfolios though to absolute/real return focused portfolios. This distinction relates to an investor's true investment objectives (return, risk, peer benchmarks, etc) and also to the breadth of the investment toolbox the investor is prepared to use. Indeed, I believe defining where an investor sits on this spectrum and the investment tools they are prepared to use is the most important part of developing an investment philosophy and approach. This is not easy because the natural inclination of many investors is to want relative returns when mainstream markets are rising, and absolute returns when they are falling.

It should be no surprise that I lean towards the absolute/real return and more alpha driven portfolios. However, these are more complex and the most difficult to implement, both practically and emotionally. Still, such portfolios are likely best suited to the current challenges and future investment outlook, although investors may choose other approaches for various reasons.

In particular, it is the unconventional nature of absolute/real return and alpha portfolio approaches that many struggle with as the business risk of going down this path is not insignificant. This concern is understandable, particularly given the increased complexity of such approaches and when the backward-looking case for such portfolios versus conventional ones is far from clear cut. As the Passport comment above implies, the pressure to stay with conventional portfolios and those most benefiting from current environment is hard to withstand.

Indeed, the temptation now to think only in relative terms is more pressing than ever. The sentiment seems to be "I must take more risk in growth assets because interest rates are so low and there is no other alternative". I think this partly explains why growth assets have become so expensive without sentiment measures becoming overly optimistic which would normally be a bullish sign. As one fund manager said, with no safe choices "there are a lot of fully invested bears".

However, it is worthwhile noting that some of the biggest equity bear markets in history have occurred at times of low and/or declining interest rates – think 2000-02, 2007-8 or even the 1930s. Very low interest rates can reflect a poor economic outlook or other structural economic problems (e.g. high debt) so the typical assumption that equities should be more highly valued in a low interest rates environment should be treated with scepticism. In any case, high valuations now may already be guaranteeing poor future returns even if those valuations levels remain elevated, as they have stolen returns from the future. Low

interest rates certainly do cause many investors to take on higher risk and push asset prices higher but whether that risk is ultimately rewarded is another matter.

Whatever approach or combination of approaches is chosen, managing investor expectations is more important than ever. For example, if they move entirely to cash, investors can wave goodbye to any real or even nominal return until normality returns. On the other hand, the probability of a conventional diversified portfolio achieving negative returns in the current environment is greater than normal and investors need to be fully aware of this. While the alpha and absolute/real return portfolios have the potential to do better and have smaller drawdowns in difficult markets, they come with no guarantees. The eventual dangers of the central bank bubble portfolio should be obvious.

Perhaps the biggest problem may not be the portfolio approach that investors choose to deal with the challenges ahead, but instead their lack of discipline in sticking with their approach. The worst losses will be born by those who commit to, but then give up on, a conventional portfolio at the worst possible time, in the throes of a major bear market. Alternatively, it could be those that give up on more defensive approach to go all out chasing risk assets supported by current low interest rates without a plan to exit or manage leverage they may take on. Ultimately, investing is as much an emotional challenge as a practical one, particularly for those approaches with a contrarian bent. The key is to recognise this when markets are calm - not when emotional pressure is soaring in volatile and difficult markets.

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