Westshore Wealth *Insights*

Thoughts on Asset Allocation in a Volatile Environment

By Robert Sigler

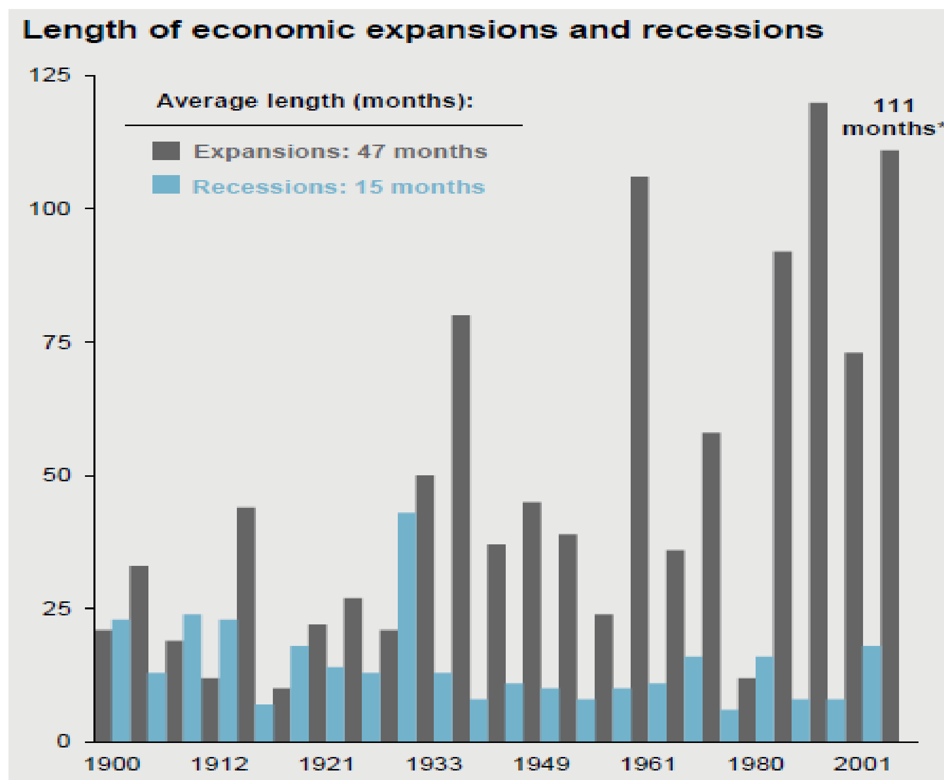
October 2018

WESTSHORE WEALTH

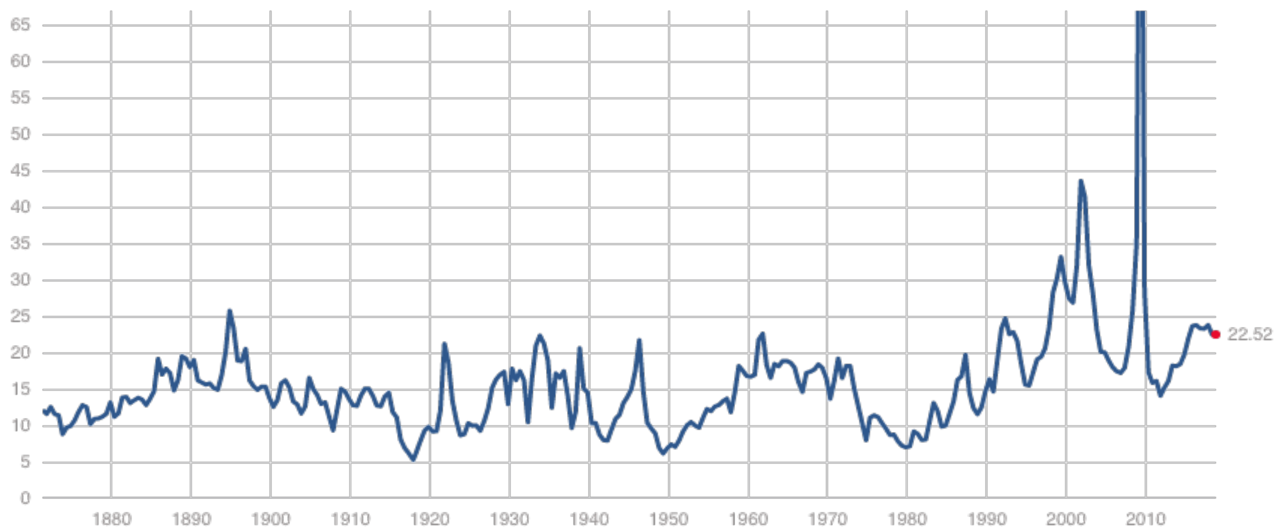
Thoughts on Asset Allocation in a Volatile Environment

In our **Investment State of the Union** piece, we outlined increasing risks to both the market and the economic cycle. While we are the first to acknowledge that trying to call a top is a fool's errand, in our effort to employ a probability weighted investment strategy, we have to look at the preponderance of the evidence to determine where we reside on the risk/reward curve. At present, the balance of the evidence is not altogether favorable. Why not? The market is in the tenth year of a bull market (a record), valuations and earnings growth expectations are relatively high, the economy is operating toward the higher end of its functional speed limit, and the Fed is firmly in tightening mode. Compounding the problem, the US is involved in broad trade skirmishes that threaten to stagnate growth and increase inflationary pressures. Given that a picture is worth a thousand words, the following illustrations tell the story of why we are concerned.

The economic expansion is long in the tooth relative to historical norms.



Valuation isn't particularly compelling on several measures. The SPX 500 trailing 12 month P/E ratio resides at the higher end of its longer term rate.

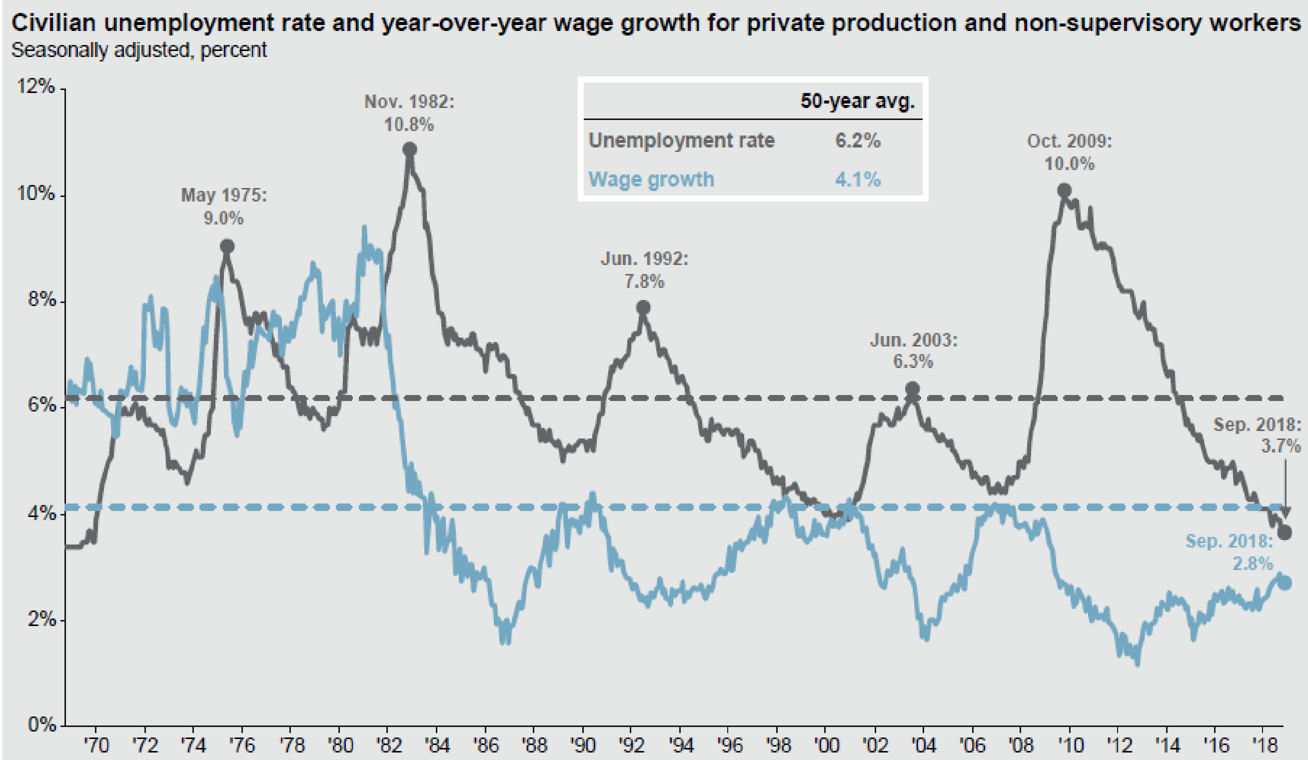


Source: www.multpl.com

Additionally, valuation models that attempt to smooth earnings over a longer period of time show even more extremes. One such measure, the Robert Shiller P/E ratio for the S&P 500, is flashing a warning sign. The Shiller P/E is based on average inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted PE Ratio.

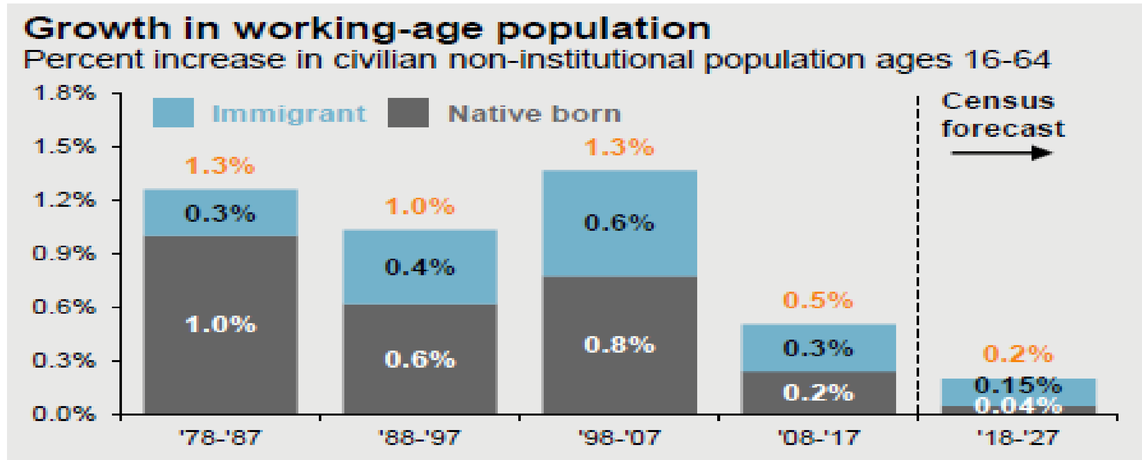
Source: www.multpl.com/shiller-pe/

The economy is operating at the upper end of its functional speed limit. As the chart illustrates below, the civilian unemployment rate is running at the lowest level since the early 1960s. We are physically running out of workers as a result. Traditionally, such tight employment conditions have resulted in wage inflation to incentivize workers to come back into the workforce. We are already hearing lots of anecdotes of companies richening benefits or outright raising wages to attract employees.

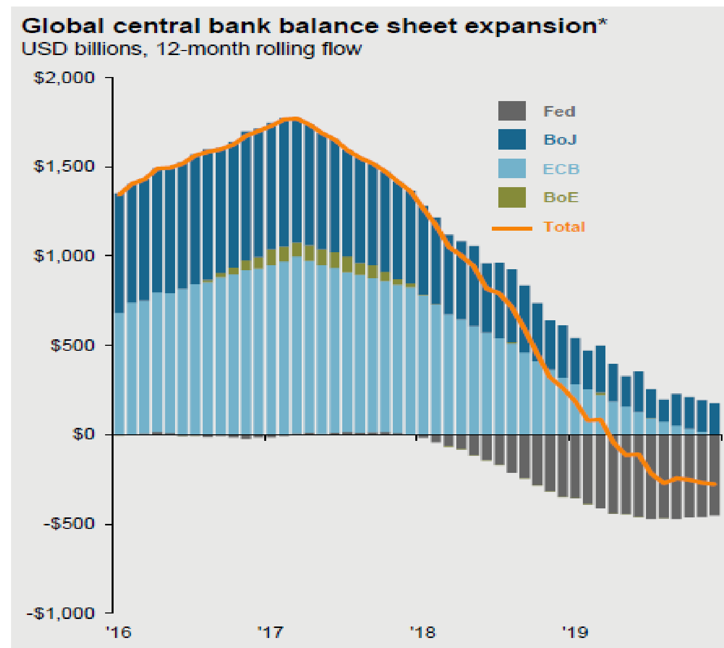


Source: BLS, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of September 30, 2018.

Unfortunately for the United States, given declining birth rates for the past twenty years, the US Census forecasts a dramatic slowdown in working age population for the next ten years. The US has typically relied upon immigration to fill some of those job voids, but that appears to be at risk with current policies. These trends have the potential to aggravate wage inflation trends.

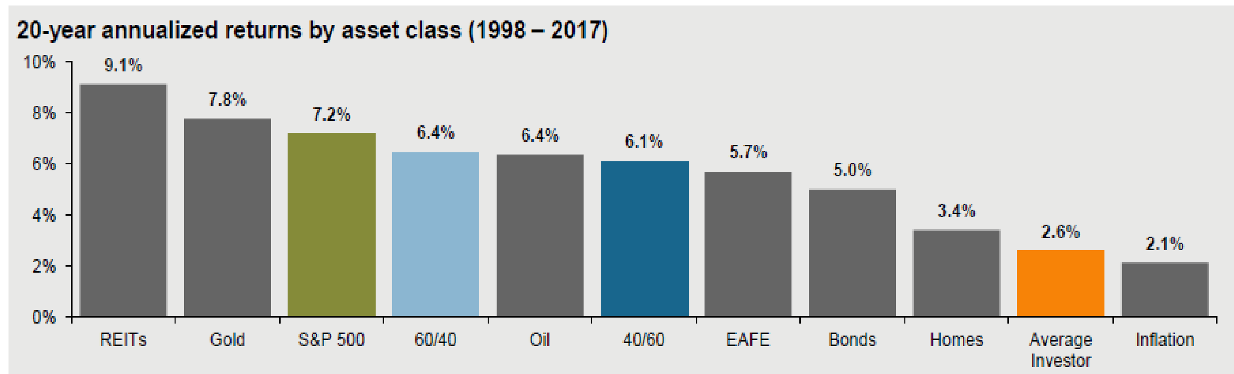


Finally, the easy money and low interest rates that have buoyed markets is coming to a conclusion. Central banks are reversing course and the Federal Reserve is firmly in tightening mode.



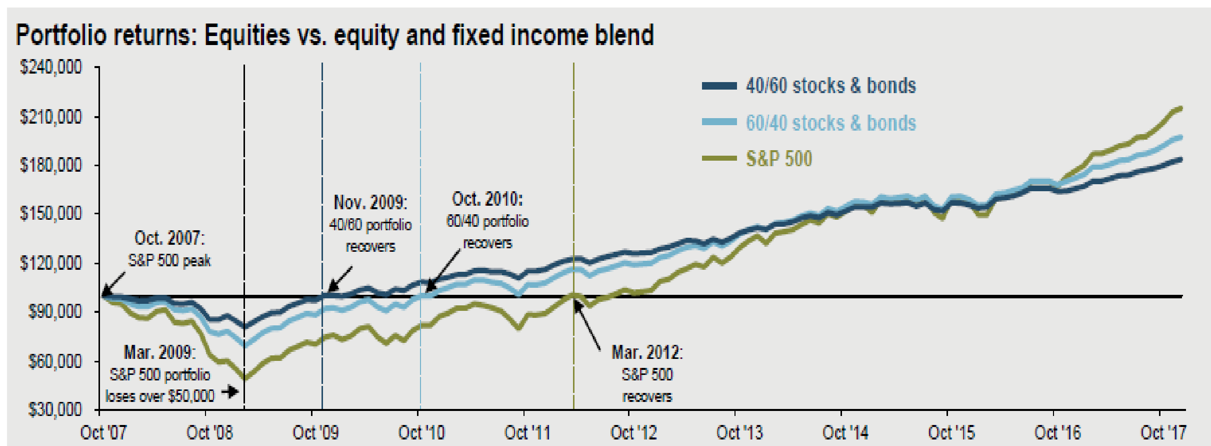
So now that we agree that risks are rising, what do we do about it? We previously argued that no one possesses a crystal ball to investing. Investors who attempt to rotate in and out of the market (market timers) have failed miserably. Quoting an aforementioned Morningstar study that examined returns from 1997 to 2017, a buy and hold strategy investing in the SPX 500

yielded a 7.2% annual return despite two episodes where the broad market contracted by >50%. However, missing the best 30 days of market returns over that same period turned portfolio returns negative (-0.9% annually). So, should we just buy and hold? The simple answer is yes. Unfortunately, plenty of empirical evidence suggests that human emotion generally overrides good investing sense, especially when confronted with extremes. Fear drives us to panic sell near bottoms and greed conspires to have us chase rallies. The net result typically means that the individual investor gets whipsawed and dramatically underperforms broad indices. The following table courtesy of JP Morgan Asset Management illustrates it perfectly. Individual investors tend to outsmart themselves, rotating in and out at inopportune moments, causing longer term underperformance (see the Average Investor column in orange).



In our Investing State of the Union piece, we opined that intelligent portfolio construction can be the antidote to rising risk and help navigating human emotion that tends to trigger bad investment decisions. Strangely enough, my 7 year old niece's request to go bowling for her birthday illustrates exactly how this can work. When Gigi arrived at the alley, she was very excited. Unfortunately, within moments, it became apparent that she didn't have the strength to propel the ball all the way down the alley. The result was a string of gutter balls. Increasingly, Gigi became disinterested, then despondent, and finally decided she didn't want to play any longer. Luckily one of the attendants noted her frustration and suggested that we deploy the bumpers (metal rails that extend into the alley to block the ball from entering the gutter). Once deployed, my niece started knocking down some pins, even recording a strike. In the end, she was all smiles and eager to return in the future. Asset allocation is analogous to those bumpers. It absolutely doesn't guarantee that you are going to record all strikes. However, the aim is to keep

the really bad outcomes (the gutter balls) out of the equation. By dampening volatility such that losses are palatable, the goal is to keep you invested, so that when the better times return, you are involved and positioned to reap the reward. Look at the chart below. It shows a $100,000 invested at exactly the wrong moment in time, October 2007, the top of the market preceding the Great Recession of 2007-2009. The illustration shows three portfolios, one based on the SPX 500, another based on a 60%/40% stock/bond portfolio, and finally, a 40%/60% stock/bond portfolio. While a pure equity portfolio outperformed all others if we fast forward to present, it wasn't until seven years later, in October 2014, that it produced a superior return. It also lagged a return to breakeven by nearly 2.5 years relative to a 40/60 blend, and 1.5 years for a 60/40 blend portfolio. Our contention is that the hypothetical investors represented by the portfolio blends stood a much stronger chance of holding firm during the turmoil, than did the hypothetical investor solely invested in equities who encountered the steepest of the downdrafts and the longest path back to breakeven.



So how do we put that into practice in terms of portfolio construction? In simplistic terms, it's easy. A portfolio needs to have diversification to navigate specific risks of a single security and should have some shock absorber, usually bonds and cash, to protect it against systemic risk, meaning a broader market collapse. Relatively sophisticated individual investors have utilized a mix of mutual funds and ETFs to conquer the diversification problem and have relied on an old rule of thumb (100 – your age = stock allocation, with the remainder in bonds) for asset allocation. While these techniques have generally been effective, your parents' asset allocation model has grown a little dusty over the years. What's changed? First, it has become clear that the

consideration set for assets needs to be broader than simply stocks, bonds, and cash. Building an adequately diverse and uncorrelated group of assets necessitates expanding the scope to include alternatives like absolute return strategies, private equity, venture capital, as well as real assets like commodities and real estate (The table below illustrates correlations between various asset classes. The key takeaway is that broader diversification enhances risk mitigation).

	U.S. Large Cap	EAFE	EME	Bonds	Corp. HY	Munis	Currcy.	EMD	Cmdty.	REITs	Hedge funds	Private equity	Ann. Volatility
U.S. Large Cap	1.00	0.89	0.79	-0.31	0.72	-0.18	-0.51	0.58	0.66	0.83	0.87	0.85	15%
EAFE		1.00	0.90	-0.17	0.77	-0.06	-0.67	0.69	0.64	0.75	0.85	0.79	18%
EME			1.00	-0.09	0.88	0.01	-0.70	0.84	0.70	0.66	0.85	0.73	22%
Bonds				1.00	-0.04	0.83	-0.12	0.27	-0.22	0.04	-0.29	-0.39	3%
Corp. HY					1.00	0.08	-0.53	0.87	0.71	0.72	0.83	0.68	12%
Munis						1.00	-0.14	0.43	-0.19	0.10	-0.12	-0.26	4%
Currencies							1.00	-0.61	-0.56	-0.44	-0.44	-0.54	7%
EMD								1.00	0.59	0.63	0.69	0.53	8%
Commodities									1.00	0.56	0.72	0.76	17%
REITs										1.00	0.71	0.74	25%
Hedge funds											1.00	0.84	6%
Private equity												1.00	10%

Second, it is generally accepted that people are living and working longer, thus necessitating larger stakes in risk seeking investments later into life. Importantly, neither of these insights are unique to Westshore. They are, in fact, commonly understood and practiced. So where can we add value in the process? Our methodology relies on constant surveillance and measurement of asset classes versus one another. We first develop a matrix of expected future returns for each asset class. Additionally, we calculate the expected variability to those returns using a group of statistical models that evaluate earning growth expectations and valuations relative to historical averages. After optimizing for return objective and risk tolerance for each individual investor, we then seek to asset allocate dynamically based on what those factors are telling us in terms of relative attractiveness.

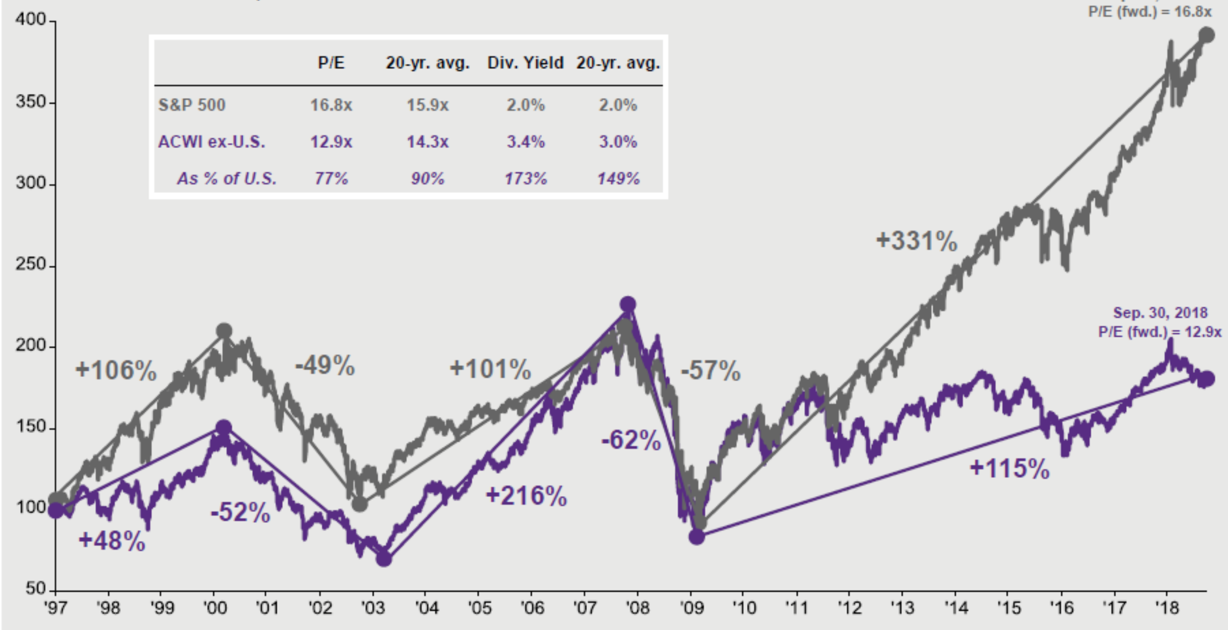
Bringing it home, our model portfolio for a balanced investor portfolio is going to undergo some changes. In equities, we remain overweight the United States, but acknowledge that this will likely change in the near future. Thematically, we will continue to favor strategies that dampen volatility and employ downside mitigation strategies to limit risk. Compositionally, you will start to see the portfolio tilt away from growth to value strategies as we expect the nine year outperformance trend of growth over value to mean revert (see table below for a clear illustration of that trend).

Since market low (March 2009)

	Value	Blend	Growth
Large	372.4%	426.3%	498.4%
Mid	474.5%	480.2%	496.4%
Small	415.8%	463.2%	510.6%

Source: JP Morgan Asset Management as of 9/20/2018

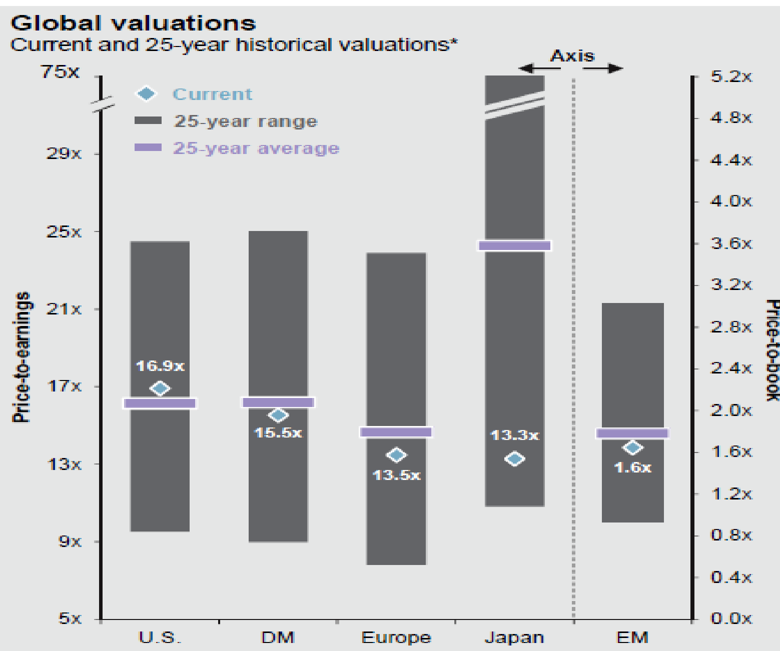
Finally, you will see us migrate our market capitalization upwards in the US as we find the small cap growth arena quite expensive relative to historical norms. With regard to international equities, we are slightly underweight. That said, we view Europe as extremely compelling on valuation and are awaiting a bit more clarity on Brexit, trade frictions, and the Italian budget before getting more aggressive. We are significantly underweight emerging market equities. We note that rising US interest rates, the strong dollar, and elevated oil prices serve as headwinds. Despite these concerns, this cohort of equities also offers the most compelling valuation.



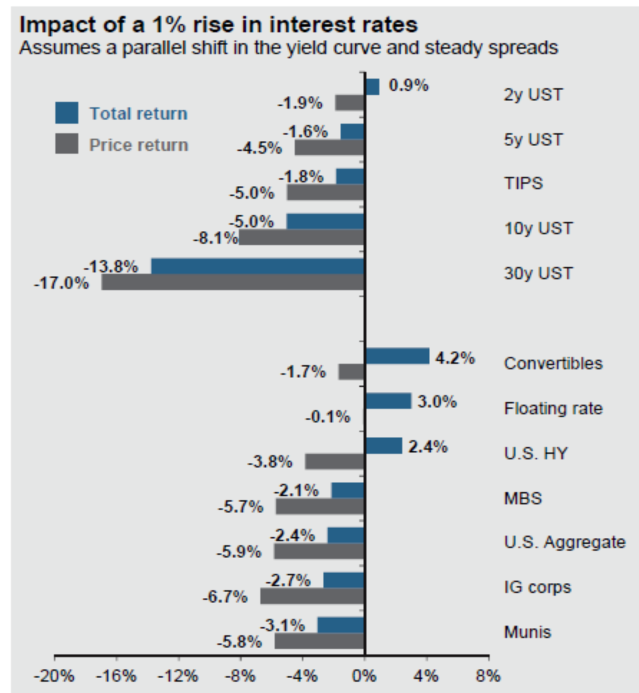
	P/E	20-yr. avg.	Div. Yield	20-yr. avg.
S&P 500	16.8x	15.9x	2.0%	2.0%
ACWI ex-U.S.	12.9x	14.3x	3.4%	3.0%
As % of U.S.	*77%*	*90%*	*173%*	*149%*

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by FactSet Market Aggregates. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of September 30, 2018.

J.P.Morgan
Asset Management



If we can start to see a reversal, or at least stabilization in those patterns, you will see us start to move quickly back to equal or overweight to take advantage of that valuation anomaly. In the meantime, our allocations to both international and emerging markets are likely to take the form of structured notes. These are slightly more sophisticated instruments that provide significant downside insulation in the form of embedded puts, and in exchange, truncate some of the potential upside for their investors. We view the tradeoff as an acceptable way to embed shock absorbers and still realize an acceptable rate of return. With regard to our capital preservation bucket, we perceive interest rate risk as relatively high in long duration bonds. The illustration below shows the impact of a 1% rise in interest rates for various fixed income instruments. It is the driving motivation for us to severely pare our exposure to funds that invest in long duration treasuries, corporates, as well as closed end vehicles that employ leverage.



By contrast, you will see us migrate exposure to floating rate securities where our coupon will fluctuate upward or downward based on market forces and pricing should be more stable. We will largely be holding pat in municipals where our structure employs ladders that reinvest maturing tranches in higher yielding securities. We acknowledge that there is risk in some longer

dated securities within the portfolio, however, we note that these bonds are held in a separately managed account that allows us to hold to term and receive par value if needed. Finally, you will see us allocate more money to short term money market funds where we can be confident of capital safety with positive return dynamics. In real assets, we will selectively allocate money into the REIT sector where yields are attractive and valuations are reasonable. We are cognizant that rising interest rates represent a risk for these assets, however, we feel that a lot of that risk has been discounted by the sector's broad underperformance. We plan to be overweight the energy infrastructure category where cash flows are predictable and the competitive moat is wide given difficult regulatory permitting and long duration construction timelines. We also view this category as a hedge on inflation. You will see us put very small weights in hard and soft commodities. While an effective diversifier with little correlation to equity trends, we will be looking for a tapering off of tariff disputes and specifically a bottoming of China's Purchasing Managers Index readings to get more aggressive on global commodities. In alternatives, we are currently evaluating multiple strategies. As rates rise, we expect to see some pain in corporations who have over-indebted themselves. Our sense is that an opportune moment could present itself to participate in distressed debt funds as the economic cycle losses steam. Meanwhile, we intend to dedicate small slices of the portfolio to longer dated venture and private equity investing.

Please bear in mind that this is a general strategy piece aimed at a broad audience. Our specific investment recommendations with regard to your portfolio will be made with an eye towards tax efficiency, time horizon, cash needs, and other specific concerns. Additionally, they will be enacted in an interactive, consultative manner.

Important Disclosures

This commentary in this paper reflects the personal opinions, viewpoints and analyses of the Westshore Wealth employees providing such comments, and should not be regarded as a description of advisory services provided by Westshore Wealth or performance returns of any Westshore Wealth Investments client. The views reflected in the commentary are subject to change at any time without notice. Nothing herein constitutes investment advice, performance data or any recommendation that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person. Any mention of a particular security and related performance data is not a recommendation to buy or sell that security. Westshore Wealth manages its clients' accounts using a variety of investment techniques and strategies, which are not necessarily discussed in the commentary. Investments in securities involve the risk of loss. Past performance is no guarantee of future results.