3Q 2021 Market Insights
The Most Difficult Problem in all of Finance:
What do I do with a Conservative Portfolio?
Michael Paciotti, CFA

"Investing is not nearly as difficult as it looks. Successful investing involves doing a few things right and avoiding serious mistakes."

- John C. Bogle

For the last seventeen years, our research efforts have produced dozens of quarterly Market Insights letters, white papers, and market flashes. In fact, being a bit nostalgic, I can recall being asked to write weekly market commentaries during the Financial Crisis, which at the time seemed a bit excessive, but essentially was nothing more than today's version of a blog or social media post, probably 5 years before that became popular. If you are counting, that's nearly 68 quarterly letters, just like this one, along with easily that same number or more of white papers, commentaries, and flashes combined. Over the years, I would argue that we've done some really unique research and have hopefully provided some valuable insights to those who have paid us the compliment of reading our work, or even the greater honor of allowing us to be stewards of their investments.

While I'm hoping this letter lives up to our insightful and value-added standard, I will admit that I'm probably not identifying anything most people, especially our financial advisor partners, have not wrangled with themselves. Regardless, I would argue the topic of this quarter's letter is perhaps the greatest challenge I've faced since beginning my investment career in 1996. During that time, I've lived through the inflation and ultimate collapse of two major market bubbles, a third if you count housing along with dot com mania, NINJA loans, credit default swaps, bank failures, a flash crash, taper tantrum, oil market collapse, BREXIT and to top it off, a pandemic. Yet, I would argue the greatest challenge I've faced is how to generate a reasonable return for a conservative investor (or conservative portion of a diversified portfolio) in an environment of record low interest rates and record high US equity market valuations, without adding meaningfully to risk. You might be thinking, but weren't some of these other major market events difficult? Each of them certainly presented their challenges. However, there is always a spot to hide if you want to take risk off the table. As we are learning in real time, there isn't always a place to go to find return without serving risk up in big doses. This quarter's Market Insights, '*The Most Difficult Problem in all of Finance: What do I do with a Conservative Portfolio?'*, will explore this issue in greater detail.

Ghosts of Portfolios Past, Present, & Future

As a conservative investor, your sources of return typically come from the same place that any investor harvests return in conventional liquid assets, that being income and capital appreciation. Portfolio structure is the backbone of that risk level, with conservative portfolios typically leaning more toward bonds and aggressive portfolios leaning more toward equities. Within each of these asset classes, there are certainly ways to add or reduce risk (which we'll get to later), but for the most part, your mix of stocks-to-bonds determines your risk. As the old saying goes; "90% of your return variability will be determined by your asset allocation."

While what constitutes conservative is somewhat subjective, most will agree that these types of portfolios typically involve a 50% or greater allocation to bonds. To be objective about this, let's split this range somewhere toward the middle, and for illustrative purposes assume a conservative portfolio will be 35% equity (28% US, 7% international developed equity) and 65% fixed income.

Historically, the conservative investor has done quite well, benefitting from an epic run in bonds coupled with a near uninterrupted gain in stocks. From 1978 to present US stocks gained an impressive 12% per year. But what is perhaps more impressive was the over 7% annualized return from the bond portion of the portfolio, leaving our conservative investor with a not too hard to live with 8.43% annualized gain for the last 40 plus years.

But is this at all repeatable or sustainable? To that question I would sadly answer no. It was a gift of unusual circumstances. Take bonds for example. In February of 1978, the yield on the 10-year treasury note was 8.03%. It should not be surprising when I say that perhaps the most easily predicted and reliable series in all of finance is long-term bond returns because they almost always produce a result that falls within a narrow range of their beginning period yield (Chart 1). If you recall from earlier, I mentioned that bonds provided a return of over 7% for the past 40 years, a mere stone's throw from the 8% beginning yield. When we take time to consider that the conservative investor-owned corporates, mortgages, long-dated bonds, and short-dated bonds in addition to the simple 10-year treasury note used for illustrative purposes, it should become apparent that bonds are a "what you see is what you get" asset.

US Stock & Bonds Face Challenges

Chart 1

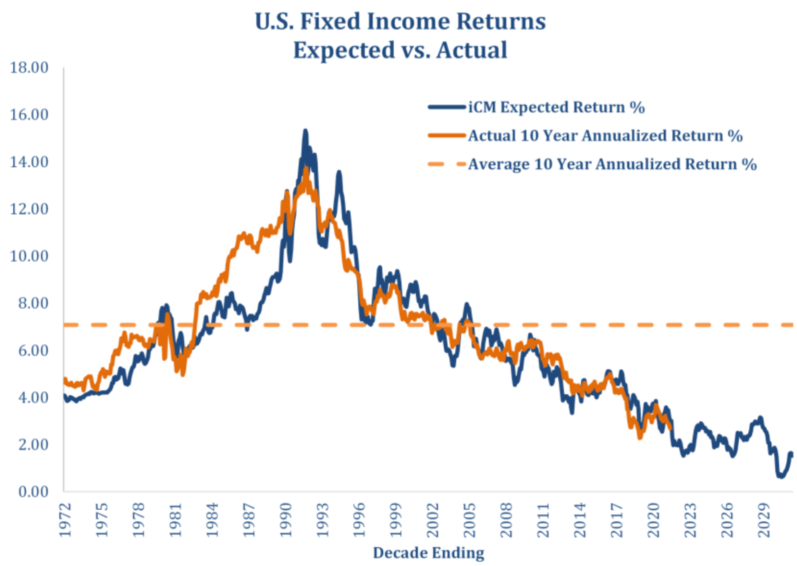
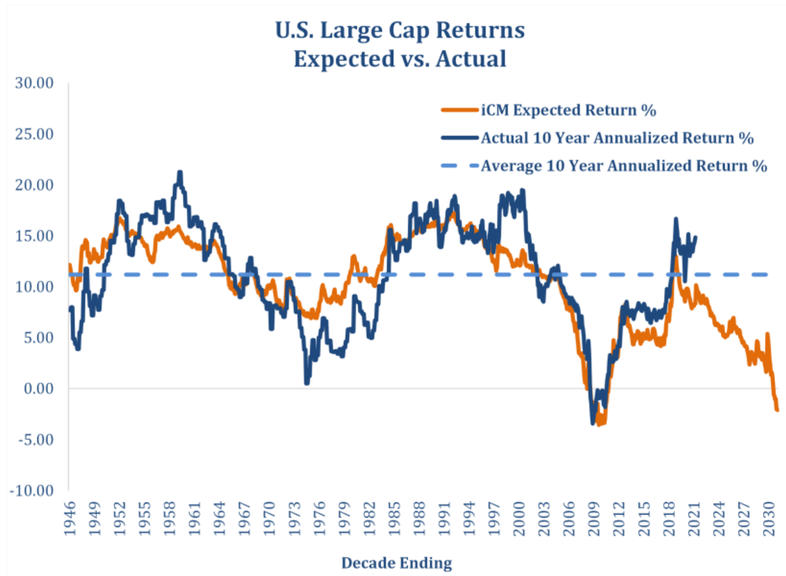


Chart 2



Source: iCM Capital Markets Research, FRB, S&P

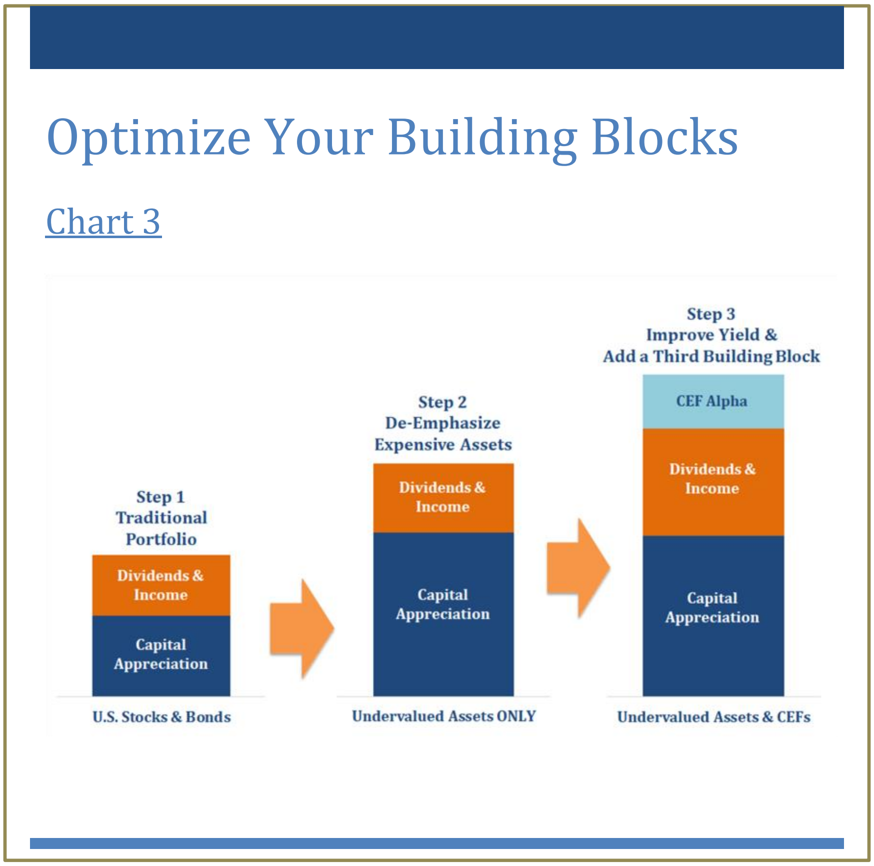
Likewise, beginning period valuations are also highly influential over the long-run on stock returns. In 1978 the US stock market traded at a Shiller CAPE Ratio of 9x earnings vs. a historical average of 17x, significantly undervalued, resulting in 40-year period of above average returns. Today that same ratio stands at 37x earnings, a level only seen once in the last 140 years, during the peak of the internet bubble. So, in the late 70's we had yields of 8% and valuations of 9x earnings vs. today where yields are 1.5% and valuations are 37x earnings. Not even remotely similar. In fact, pretty much polar opposites. By our estimation, this would place the range of expected returns of our simple conservative portfolio between -.43% and +2.37% annualized for the next decade.... gross of all management fees and expenses. Problem? You bet.

The Good, Bad & Ugly of Possible Solutions

In the preceding paragraphs I've identified the problem. Low bond yields and high equity valuations are wreaking havoc on an investor's ability to create return without taking on monumental risk. So, what should I do? There are a range of options that have been discussed in popular media, particularly as alternatives to traditional fixed income, all with some plusses and minuses, but mainly just with minuses. Owning more stocks in lieu of bonds sounds great on the basis that stocks may give you a higher return, but they also give you four times the volatility. If you anticipate a 30-40% decline would send you scurrying to cash, don't own an asset that can decline 30-40%...at least not in great proportion. A simple, but often overlooked function of bonds regardless of their return is that they dilute the risk of stocks. Similarly high yield bonds or floating rate notes provide the allure of greater yields with the tradeoff of higher risk, specifically the risk of default. Investors in these assets face the very real possibility that some portion of what they own may simply walk away from repayment. There is a time and a place to embrace this risk, usually when the reward is substantial enough to justify taking it. Today, with yields of 3.75% for traditional HY and 3.70% for bank loans, "the juice", as they say is just "not worth the squeeze."

Our Approach

While there are probably several ways to approach this problem, they all share one characteristic. To solve it, one must embrace being different. Conventional portfolio techniques lean heavily on US assets. In our example, the bond portfolio is 100% US bonds, and the equity portfolio is 80% US stocks. What happens when US stocks and bonds decline when they account for 93% or more of your portfolio, as they do for most investors? You're in trouble. The simplest solution, which might be the most difficult to embrace, is to just own different things. Overdiversify if you will, not only among asset classes, but among vehicles like closed end funds that offer the opportunity to capture greater yields, as well as additional returns from those funds trading at discounts to their underlying value (NAV). The potential benefits of doing so are illustrated in Chart 3. With a traditional portfolio, like the conservative portfolio in our example, returns come from income and capital appreciation. When interest rates in the US are low and valuations are high it becomes nearly impossible to generate a meaningful return from these sources. The path to correcting this, in our opinion, begins with owning inexpensive assets in greater quantity and correspondingly expensive US assets in much smaller amounts than most do. Owning other markets like emerging markets stocks and bonds, as an example, that provide a better valuation and interest rate picture, correspondingly present a higher probability of generating returns that approximate what most would consider to be reasonable or



normal. But what about diversification? Should we abandon the US entirely? Honestly, for most, eschewing US assets entirely probably isn't a realistic solution, mainly because it is so different and there are few that have the patience to allow that strategy to work for them. Investors need to diversify, but do so in a way that their diversification isn't a wasting asset. We advocate obtaining diversification within US markets, but do so using closed end funds. By buying closed end funds trading at a discount to NAV we can potentially improve our diversification experience by buying $1 worth of assets, but paying less than $1 to do so. This creates the opportunity to add a third building block of return as those CEFs move from a discount back toward NAV. A second, but not insignificant benefit, is that buying at a discount increases the portfolio's yield, much in the same way that buying a discount bond does. If you buy a 10-year, 5% bond at par, your yield is 5%. If you buy the same bond trading at a 10% discount to par, $900, your yield becomes 5.55% ($50 divided by $900). The yield is higher because you paid less for the bond. The same thing happens in CEF space, yield is influenced by the discount. The resulting portfolio is one that we believe is suited to answer the bell during a time when quite frankly most portfolios struggle.

Conclusion

Historically, conservative investors have been able to find adequate return in a number of places. Longer-term bonds have provided gains of about 7% per year. Even in recent times, like the past 5 years, they averaged 3.35% per year. Today, yields, a very reliable predictor of future bond performance, are about 1.5% on the 10-year treasury, indicating that a decade of sub-2% bond returns is likely. US stocks are an asset that most investors expect to generate a double-digit return. Today, trading at a Shiller CAPE of nearly 37x (more than double the historical average), the probability of that occurring is less than 1%, with the likely range of returns being between -8% and +4% per year for the next decade. When you blend these together you can see the makings for a lousy decade for all traditionally diversified portfolios that lean heavily on US assets, especially conservative portfolios.

A potential solution to this is to own inexpensive assets outside of the US. This risk can be diversified using closed end funds that offer the benefits of discounts to NAV and increased yields. In our opinion this takes several steps toward solving what could be another lost decade for investors, the second in the last three. We remain uniquely suited to respond to these needs on behalf of our clients and advisor partners. As always, we thank you for your continued trust and confidence.

Integrated | Capital | Management

The TekRidge Center
50 Alberigi Dr. Suite 114
Jessup, PA 18434
Phone: (570)344-0100
Email: info@icm-institutional.com
www.icm-invest.com