All In Good Time

Investors that rely on their portfolios to provide periodic distributions e.g., retirees, foundations, endowments, pension plans adopt an asset allocation that contains enough equity (growth) exposure to ensure long-term/perpetual support for the investor and balance it with an allocation to fixed income to dampen short-term volatility. Over time, many “conservative” growth investors gravitated towards a 60% equity / 40% fixed income allocation (standard target for most “balanced” funds) and have historically experienced successful long-term results. Over the past thirty years, a simple 60% S&P 500 / 40% Barclays Aggregate combination has produced a 10% annualized return (6.9% real return), providing consistent annual support to the investor and real growth for the portfolio. However, rarely has the disclaimer past performance is not necessarily indicative of future results been any more relevant - past performance is highly unlikely to be indicative of future results.

Most bonds are math - the purchase price is known, the coupon/interest/principal payments are known and the time horizon is known. Assuming no credit event (default), the return on a bond is captured at the time of purchase and is reflected by the yield to maturity or the current yield if you assume the bond is purchased at par and held until maturity. As a result, it is fairly easy to generate an expected return for a traditional bond portfolio. The chart below shows the Barclays Aggregate Index historical yield and the corresponding five-year forward return.
The point of this analysis is to illustrate the historical accuracy of the yield/future return relationship and more importantly establish reasonable expectations going forward. Assuming the Barclays Aggregate Index’s 2.34% current yield (7/31/13) is a useful indicator of the investment-grade bond market’s expected performance over the next five years, 60/40 allocated investors hoping to replicate the success of the last thirty years, need their growth components to earn more than 15%, annually.

We recognize very few investors expect returns during the next investment cycle to be as rewarding as the past thirty years. Though the potential headwind provided by fixed income allocations could significantly reduce the probability of achieving even modest growth objectives, which could significantly impact future support for the investor.

This challenging outlook for fixed income investments is not new and is widely discussed and understood throughout the financial community. Welch Hornsby took steps several years ago to reduce interest rate risk within client fixed income portfolios by recommending shorter/flexible duration bond vehicles. Fortunately, over this time period credit spreads continued to tighten and growth portfolios experienced robust gains, resulting in solid absolute returns. However, going forward, assuming interest rates remain low, 60/40 investors have three options: (1) hope the growth component of the portfolio delivers outsized returns; (2) reduce the amount of support provided by the portfolio; or (3) revisit the asset allocation.

Hope is not an investment strategy and investors should not be dependent on it for future success. Investors have taken steps to reduce their dependence on high returns going forward by saving more, reducing expected returns and differentiating between desired support and required support. Yet for some investors, option three should be considered.

**Bond Allocation Revisited**

There are numerous reasons why an investor incorporates bonds into a portfolio but near the top of that list is to reduce overall portfolio volatility. Modern Portfolio Theory states that the variability of price or price volatility represents an investment’s/portfolio’s “risk.” Therefore, any decision to reduce exposure to bonds would likely be accompanied by an increase in volatility/risk.

<table>
<thead>
<tr>
<th>Asset Allocation</th>
<th>100%</th>
<th>90%</th>
<th>80%</th>
<th>70%</th>
<th>60%</th>
<th>50%</th>
<th>40%</th>
<th>30%</th>
<th>20%</th>
<th>10%</th>
<th>0%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>100%</td>
<td>90%</td>
<td>80%</td>
<td>70%</td>
<td>60%</td>
<td>50%</td>
<td>40%</td>
<td>30%</td>
<td>20%</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>Bonds</td>
<td>0%</td>
<td>10%</td>
<td>20%</td>
<td>30%</td>
<td>40%</td>
<td>50%</td>
<td>60%</td>
<td>70%</td>
<td>80%</td>
<td>90%</td>
<td>100%</td>
</tr>
<tr>
<td>Volatility</td>
<td>15.3%</td>
<td>13.8%</td>
<td>12.4%</td>
<td>11.0%</td>
<td>9.6%</td>
<td>8.3%</td>
<td>7.0%</td>
<td>5.9%</td>
<td>5.0%</td>
<td>4.4%</td>
<td>4.3%</td>
</tr>
</tbody>
</table>

Many people argue volatility alone is not risk, but it certainly contributes to several substantial real risks, most notably *emotional risk* and *timing risk*. 
Emotional risk – volatility can cause investors to second guess their investment decisions leading them to make emotionally charged decisions/changes at the wrong times. Emotional risk tends to be one of the largest obstacles to long-term investment success as investors chase returns. Warren Buffet, in the Preface to Benjamin Graham’s investment classic, The Intelligent Investor states “To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.” Welch Hornsby has published numerous research papers on emotional risk and how we attempt to manage it within client portfolios. A clear expectation of how increased volatility could impact short-term return profiles would be critical before changing the overall asset allocation.

Timing risk - volatility can magnify errors made in horizon planning, especially within portfolios with external cash flows. Long-term portfolios should focus less on volatility, while short-term investors are gambling with their money in volatile asset classes. As a result, any decision to increase volatility within a portfolio with external cash flows should address short-term cash needs to ensure there is no near-term asset/liability mismatch that could force the investor to liquidate an investment during a period of downside volatility, turning a potentially temporary decline into a permanent loss.

Hybrid Framework for Portfolio Distributions

Consider a portfolio structure that views bonds as “time” by matching near-term assets and liabilities. As an investor increases the allocation to bonds (matches more/longer liabilities) the portfolio has more “time” to allow the capital appreciation segment to smooth its ups and downs.

For example, assume an investor wanted to buy five years of time. The initial liquidity portfolio might hold the current year’s liquidity needs in cash and a laddered bond portfolio would match four additional years of liquidity needs so that each year proceeds from the maturing bonds would fund the annual distribution. After year one if the capital appreciation segment of the portfolio generated real growth, an additional year of time would be added by refilling the fifth year liquidity bucket illustrated below in the Favorable Market Environment – Example. However, if the capital appreciation segment of the portfolio had a negative year, there is no immediate need to replenish allowing markets to recover as shown in the Unfavorable Market Environment – Example chart.
This dynamic re-balancing process could potentially take advantage of market volatility by harvesting gains from the capital appreciation portfolio to buy more “time” when the market environment is most favorable to do so as shown below in the Normal Market Environment – Example.
Under this framework, the capital appreciation component of client portfolios should incorporate a diversified portfolio of strategies with varying time horizons (5+ years). See our recent Viewpoint “The Price of Success” for a detailed overview of how we differentiate/allocate between return-enhancing and risk-reducing strategies.

For some accounts with high distributions, this approach may not be feasible. For other accounts with no distributions, this approach may not be necessary. However, as we look for creative ways to reduce the potential fixed income headwind going forward, this hybrid structure may provide a framework for navigating a low interest rate environment.

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