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Investment Insights

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Growing & Protecting Wealth in a Lower-Return World

- Why diversified portfolios may now be making a comeback in style.
- The best measure of a portfolio's true value is the *sustainable income* stream it is likely to deliver.
- Key strategies for improving an investor's lifestyle and portfolio over the long run.

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While maintaining a diversified portfolio may have gone out of fashion this past year as U. S. stocks soared to record highs, it appears this time-tested approach to creating wealth and achieving important goals may be coming back in style as investors look to **mitigate the risks of a third financial bubble in the last 15 years.**

While many commentators in the news and financial media have described the recent global stock market turmoil as "historic" and "unprecedented," its evolution has been quite traditional so far.

This selloff started as a repricing of global growth prospects and the increased likelihood of a global slowdown. It accelerated as fears spread that policy makers may not be able to respond quickly and effectively. Part of this worry had to do with the extent to which central banks have depleted their ammunition (tools) after years of highly experimental policies of zero-bound interest rates and Quantitative Easing—the Fed being the printer and primary buyer of its own debt—to promote economic growth.

As is often the case, the selloff further gathered steam as volatility-sensitive investors realized that their portfolios may have become *massively* over-concentrated in only a few asset classes, such as large company U.S. stocks (think S&P 500).

These are the typical stages of a generalized market selloff that, over the short term, will often spread to most all other asset classes as panic and fear sets in.

Unfortunately, diversification is least wanted and most painful when it's most needed: In a very mature late-stage bull market and when diversifying investments are currently suffering through a bear market (i.e., are getting cheaper).

Measuring a Portfolio's True Value

Most people measure wealth in terms of the *dollar value* of a portfolio. We believe investors—whether corporate pensions, foundations, endowments, or individuals—need to focus on ***"sustainable income."*** This is key to effective planning and ***provides spending power***, whether needed currently or, which may be needed sometime in the future. What do we mean by this, and why does it matter?

An interesting study on sustainable income shows that **bear markets have a limited impact on a portfolio's income stream**. For example, let's consider the single worst bear market in U.S. capital markets history—the Great Depression.

From September 1929 to June 1932, for the diversified investor, especially one who had the discipline (and the courage) to rebalance into the crashing market, the portfolio value would have dropped. But, the ***sustainable income would have increased by 33%***! Let me explain:

> A diversified portfolio (60% stock/40% bond) starting at $100,000 sported a yield—interest and dividends—of 3.35%, which provided $3,350 of spending power annually. (It's hard to imagine today that people thought this yield was shockingly low!) Even though the portfolio value would have dropped to a temporary market crash low of $48,000, there was good news in the midst of this very serious market debacle. ***Well managed companies continued to pay dividends and interest***—and as a result of the price drop, stock market yields rose from 3.1% to 13.1%. The diversified investor who rebalanced, would see the portfolio income rise to $4,483 during this same period.

It's important to remember that there is a grave difference between a temporary loss of value (from panic and fear) and a permanent loss of capital (from companies going bankrupt or defaulting on loans).

Keep in mind that rebalancing during volatile markets *feels* very painful. But through the lens of sustainable income—measured in income distributions—the "loss" disappears. Although the market downturn during the Great Depression was devastating, the cost of living also fell. Because portfolio income increased, **the <u>patient</u> investor's lifestyle actually improved.**

The real devastation on investment capital during the Great Depression was neither from the plunge in portfolio values, which was daunting, nor from a plunge in sustainable spending income from portfolios of any investor who was unleveraged, well-diversified, and did not panic. The real devastation was from <u>taxes</u> and <u>people who borrowed money</u> (leveraged) to invest in the stock market. Even the loss of capital was temporary. The recovery was immense as the portfolio's spending power and value went on to achieve new highs.

Key Strategies for Growing and Protecting Wealth in a Volatile World

■ **Contributors to Return:** The key contributors to our return expectations over the next 3-5 years are ***income*** (yield) and ***growth in income***.

Over the past 10 years, most of the per annum return of portfolios came from the marvelous <u>valuation</u> tailwinds (increases) resulting from declining interest and inflation rates. From today's starting point, we're reasonably sure the <u>central bank's current interest rate range of 0-0.25% will not go much lower</u>. Sure, changing valuations play a part, but they should not—and likely, will not—play a major role in setting our expectations over the next 5 years.

Today, most portfolio strategies generate a yield of less than 2%. All of our portfolio strategies have much better yields, ranging from: 3.6% in a capital growth strategy to 4.3% in a current income strategy. On average, these profoundly diversified strategies generates a yield of over 3.9%, nearly twice that of traditional portfolio strategies.

■ **Sustainable Spending:** Many of the challenges pensions, endowments, foundations and retirees will be facing in the future will stem from (1) unrealistic return expectations and (2) a desire to spend more than market returns can support.

With stock yields below 1.5% and bond yields of 2.5%, analysis of the building blocks of return for most assets shows that investors cannot expect to receive the commonly assumed 7-8% percent returns in the future. Our industry pays scant attention to the concept of *"sustainable spending,"* which is key to effective planning. Neither the *need* for a particular rate of return nor the *hope* for performance that can sustain outsized spending allows us to *expect* that return. **Hope is not a strategy**. We need to know how much we can spend, if we want to increase the likelihood of obtaining the returns required to achieve our financial objectives.

Sustainable spending is not a fixed rate. It changes as yields change. If we can't rely on the valuation increases (which we can't), then portfolio strategies that boast meaningfully higher yields and higher prospective income growth will tend to outperform substantially in the future.

■ **Continual Rebalancing Across a Vast Span of Markets:** This process is key to reducing concentration risk and harvesting returns. By rebalancing your portfolio to its targeted mix each quarter, we provide a systematic way to *shift away from popular asset classes when they are overvalued* (sell high) and *move into asset classes when valuations are fundamentally attractive*—at the times when they are feared and shunned (buy low).

To shift our focus from the dollar value of our portfolio to its sustainable spending power can be difficult, even uncomfortable. Whether accumulating capital for a long term goal (10+ years), distributing income for current spending needs, or simply reinvesting the dividend income to increase future spending power, such a shift will require the resolve, discipline and courage to temper our inherent human instinct.

For those who focus on spending power, market downturns can turn out to be terrific opportunities to rebalance into high-yielding assets—as the 1929 stock market crash example showed—offering the opportunity to increase sustainable spending power even higher.

Soon enough, history will show that (1) valuations, like the force of gravity, matter and (2) a diversified, disciplined investment process rewards.

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