Where to From Here?

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What a strange year, huh? Despite the steady performance of the S&P 500 it's actually been a remarkably difficult year in which to make a decent return. If you haven't been 100% allocated in US stocks (or the Japanese rollercoaster) you've likely seen a pretty rocky return. See the following year-to-date returns for some of the major asset classes:

- 30 Year T-Bonds: -5%
- Yen: - 8.2%
- Copper: -12.5%
- Gold: -17%
- Silver: -27.3%
- CRB Index: -3%
- Shanghai Composite: -4.9%
- Brazilian Bovespa: -15.5%
- German DAX: 6.2%
- HFRX Global Hedge Fund Index: 4.55%

If you'd bought a 60/40 portfolio of S&P 500 and the iShares Aggregate Bond index you'd be up 8.6% this year. Not bad. It's even better on a risk adjusted basis, yet on the surgace appears to be lacking when compared to the 15% return in the S&P 500. So when we step back we can only marvel at the fact that there has been almost no negative volatility in the S&P 500 this year. It's truly incredible.

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Did you know that a 60/40 stock/bond portfolio has achieved 75% of the pure equity return with 50% of the risk YTD?

Obviously, I view the world of portfolio management through a much broader lens than the S&P 500. It's nothing more than convenient cherry picking to perpetually point to an index of 500 stocks or the class of assets that represents just a 20% slice of the private sector's assets. The world's a much bigger place than that and the asset class spectrum should be viewed through a much broader lens.

So, what should we make of the recent 5% slide in U.S. stocks and all the bond volatility? Is it the beginning of something larger or will the market simply bounce again and move higher?

The Role of Bonds in a Portfolio

First, I think it's important to inspect the 60/40 portfolio a bit further in order to highlight an important concept.* If you look at the iShares Aggregate Bond Index (formerly the Lehman Aggregate) you'll see a negative total return year-to-date of about -2%. That's a huge –17% underperformance when compared to the equity market. But it's actually not far from what we'd expect bonds to do in a year when stocks have experienced so little negative volatility. Risk aversion leads to less hedging with non-correlated assets like bonds. That can be good for equities, but signs of a dangerous trend.

Fixed income is a natural portfolio stabilizer. And it's simply another way to allocate your portfolio to the output of a specific entity. Since fixed income is always senior to equity in the liquidation process AND provides a safer and more stable return, it can actually achieve the same basic goal that equities achieve without the same level of risk (which, at times, also means lower returns).

Now, the iShares Aggregate has returned –2% this year. But if you combined that with a traditional equity portfolio in a 60/40 weighting you generated a healthy 8.6% return. And you did so with a standard deviation of 3.1. That compares with the equity market return of 15% at a standard deviation of 6.2. In other words, you generated 75% of the pure equity return at 50% of the risk. Not bad. Of course, we should look more broadly at what "risk" is, but for simplicity I hope you get the message here. Even in a year when bonds are performing poorly they're still providing portfolios with a stabilizing factor. I don't know about you, but that helps me sleep at night knowing that my portfolio is not on the pure equity rollercoaster ride being exposed to all that extra risk that isn't justified by the return.

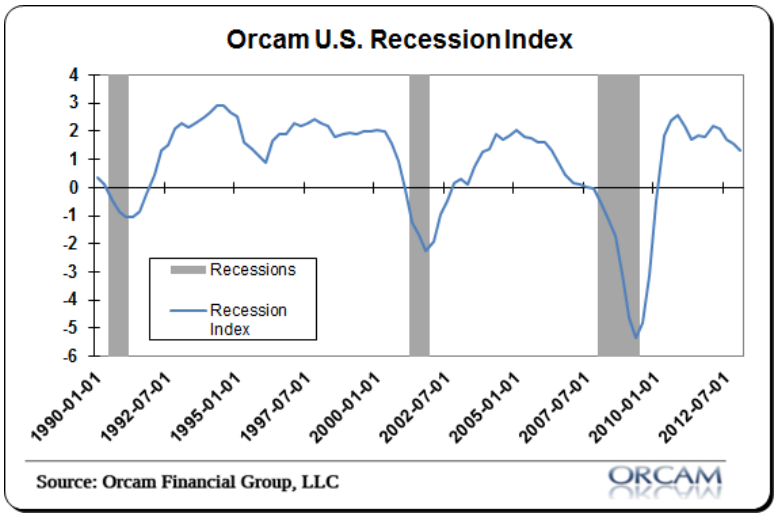
** I am using the 60/40 because it's a common benchmark, not because I think that's necessarily appropriate for everyone or even ideal.*

Further, given the buoyancy of stocks and the drag from fixed income, I think the likelihood in the coming quarters is for this stabilizing effect to become increasingly important. That is, equities won't stay in this zero negative vol world forever and when they revert to a more volatile state you'll be happy you have a fixed income allocation of some sort.

Perhaps most importantly, this shows how dangerous it can be to just glance at year-to-date performance without looking under the hood. If there's one thing you learn from the research I hope it's that you'll begin focusing on risk adjusted returns. As I showed with the 60/40 example the story is MUCH more complex than 15% vs –2%.

Getting More Granular

From a core strategic position I remain quite bullish on stocks. Recent data hasn't changed this view despite some softening of economic news. We've seen weakness in manufacturing data, some softening in industrial production, a bit more volatility in employment data, but the overall picture still points to growth in the USA.

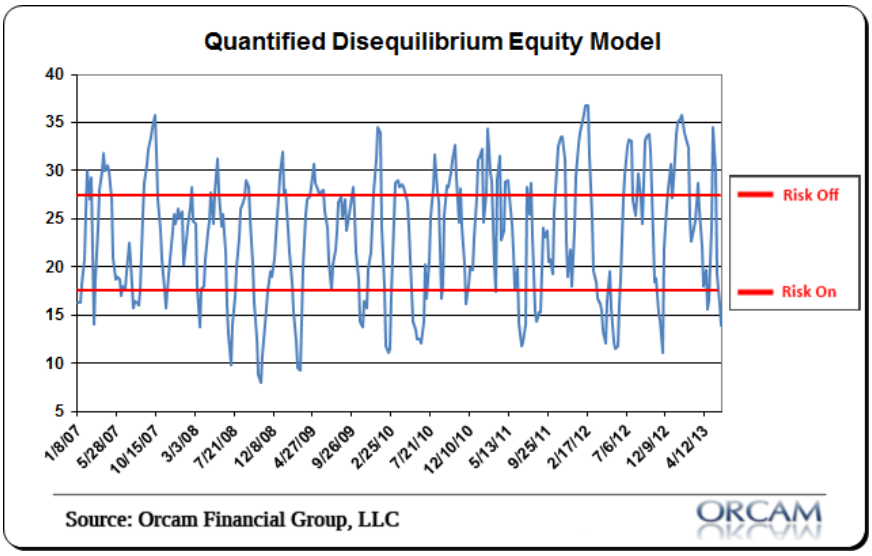


The Orcam Recession Index is trending lower, but still remains solidly positive. So far, this has served us well and kept us from being fooled into thinking that *weak* data was necessarily *bad* data.

From a more tactical position the equity markets looked improved after the -5% slide in recent weeks. My primary tactical indicator, the QD Model hasn't served us well this year and has been so volatile that anything that isn't automated has been hard to capitalize on. That's not surprising given the fact that there has been almost zero negative volatility and the longest downturn of the year has literally lasted a few days. Timing that kind of market move is impossible and it's markets like these that justify a more passive approach. Still, it's interesting to note that, even with the cautious tactical view for much of the year you can still generate a decent return using this sort of a core and satellite approach in a year when the satellite doesn't contribute much. For instance, if you'd entered the year with a 60/40 portfolio and shifted the equity component to 20% cash (40/40/20) you'd have generated a 4.6% return with a 1.6 standard deviation. In other words, your account would have acted very close to a money market account with about 5X the money market return.

Again, not bad given the performance of various assets classes. And if you could do that every 6 months people would start accusing you of being Bernie Madoff.

That said, the model is slightly positive at present. I generally automate this to purchase equities when an upside reversal occurs so it's much more constructive than it has been, but not yet what I would call "bullish". So you can continue to call me a long-term bull with some near-term caution embedded in the portfolio.



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