ALTERNATIVE PERSPECTIVES

Macro Strategy & Research

November, 2014

The Orcam Report—The Investor's Conundrum

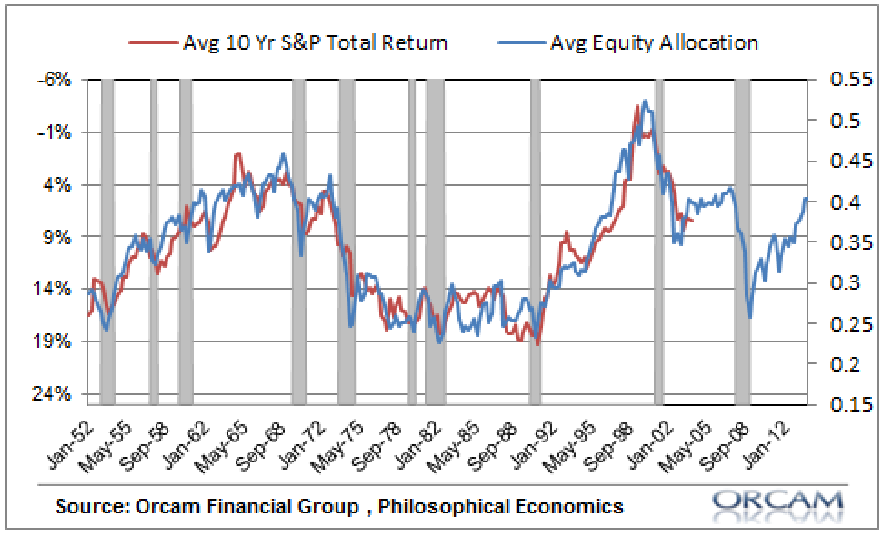
Cullen O. Roche
Founder
Orcam Financial Group, LLC
cullenroche@orcamgroup.com

"It's always different this time."

One can easily make the case that the next 40 years will be an unusually difficult period for investors. Not only is there growing evidence of slowing global growth, but we are now at the latter stages of an epic bond bull market. And this means that asset allocators will be forced to approach the future investment landscape in a very different way than they have in the past. Make no mistake—the next 40 years will look nothing like the last 40 years. It is most certainly "different this time".

The past 40 years were an incredible period of prosperity for the financial markets. Despite some recent turbulence a standard 60/40 stock/bond portfolio generated a compound annual growth rate of 9.5% with a standard deviation of just 11.5 and a max annual drawdown of -22%. But what's so interesting about this period of falling interest rates is that a 20/80 stock/bond portfolio generated a 8.3% return with a standard deviation of just 6 and a max annual drawdown of just –3.8%. A 100% total bond aggregate did almost as well with a 7.4% CAGR, a standard deviation of 5.5 and a max drawdown of just –2.7%. In other words, bonds have contributed to portfolios in the last 40 years in a tremendously positive way by reducing overall volatility while also generating relatively high returns.

This creates a tremendous conundrum for investors going forward. With the 30 year US Treasury Bond yielding just over 3% it doesn't take a rocket scientist to figure out that bonds aren't going to generate 7%+ returns in the future. The median buyer of last month's 30 year T-bond auction is looking at a yield to maturity of about 3%. This is a full 4.8% lower than the average return over the last 40 years.

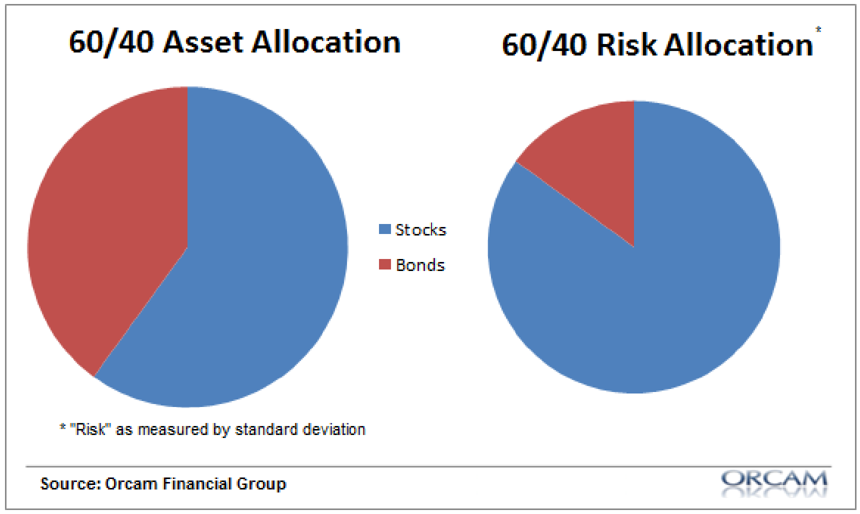


When we look at the macro picture the equity story doesn't look all that much more enticing. We know that the average 10 year future return of the S&P 500 tends to have a very high correlation with the current average aggregate equity allocation. The average equity allocation in the USA is consistent with future returns of just 6%. This means that the traditional 60/40 portfolio could be looking at a nominal return of just 5.5% in the coming decades. In fact, despite strong bond performance in the past 10 years we've already seen the 60/40 total return drop to 7.4% from the 40 year average of 9.5%. If my practical calculations are close then that figure is likely to continue dropping in the future.

If, by some chance, stocks outperform their past returns thereby making up for the lost return in bonds they would likely increase their overall volatility in the portfolio by 20% in order to generate the same 9.5% nominal return that investors have grown accustomed to. This 20% increase in volatility would be consistent with previous periods of high returns. This means you will be relying on an inherently more risky component of your portfolio to drive home the same return thereby resulting in a lower risk adjusted return.

This issue is compounded by the fact that a 60/40 portfolio is already substantially overweight equities. That is, over 85% of the volatility in the portfolio is due to the equity market component. If bonds don't generate the same high returns that they have in the past then it's highly likely that portfolios like a static 60/40 will fail to generate not only the expected nominal returns, but will also fail to perform well on a risk adjusted basis because the portfolio will be increasingly driven by the stock market component of the portfolio. In other words, there is a high probability that the correlation between the 60/40 and a 100% stock portfolio will increase in the coming years as bonds generate low historical returns.

This creates a tremendous conundrum for the average investor. At a time when "passive" indexing appears to be gaining tremendous assets under management it is highly probable that many of these portfolios will fail to generate the returns that have led to their popularity. In other words, many indexers are essentially chasing an era of high bond market returns without forecasting the high probability of low returns in the future.



In our view, portfolios need to be constructed in a more dynamic manner so that they account for this changing risk landscape. A static approach using a linear non-forecasting model does not properly account for the high probability of the upcoming low return and high risk environment. Asset allocators who are able to proactively allocate assets to account for the dynamic nature of the business cycle and the relative risks of asset classes will generate far superior risk adjusted returns than those who apply a static or linear portfolio modeling approach to their portfolio construction process.

Important Disclaimer

Orcam Financial Group, LLC

Orcam Financial Group, LLC is a fee only financial services firm offering macro research, personal advisory, institutional consulting and educational services.

ORCAM