ORCAM | ALTERNATIVE PERSPECTIVES

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The Orcam Report –The Most Important Question

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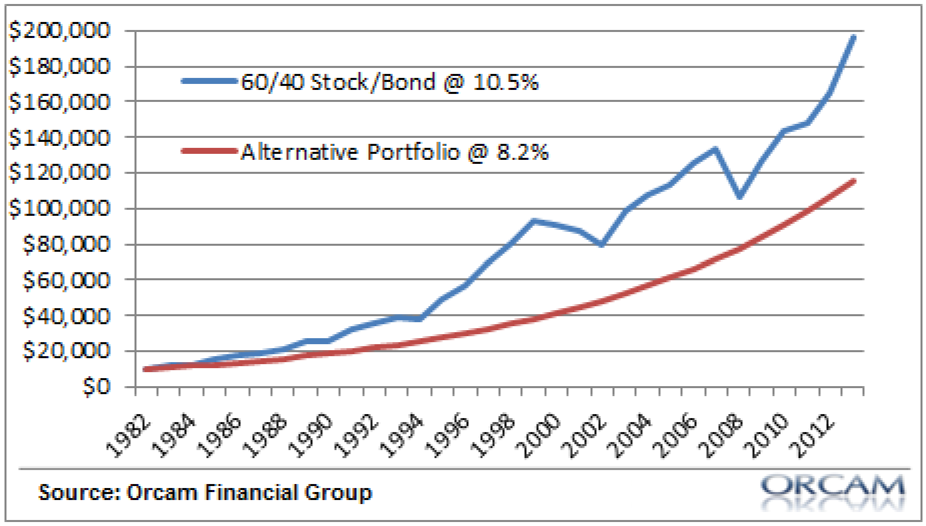
Any good asset allocation approach has to involve some implicit forecasts about the future. Of course, it's hard to know where you're going unless you understand where you've been. But that can be a tricky situation in the investment world where we all know that past performance is not indicative of future returns. Nevertheless, we can look at the past to better understand the likelihood of future outcomes. And when we combine this with a sound understanding of the capital structure and the likelihood of future returns we can put together what is hopefully a smarter way to position portfolios.

> A World of Lower Future Returns Will Push Many Investors out of Their Comfort Zone.

The Problem of Bonds

As I described in the November Orcam Report, the low interest rate environment creates a particularly daunting task in the coming 30 years for all asset allocators because the next 30 years are unlikely to look anything like the previous 30 years. We know, with a high degree of certainty, that the bond portion of a balanced portfolio simply cannot generate the tremendous nominal or risk adjusted returns that it did in the period from 1980-2014. The math just doesn't work. During this unique falling interest rate period the Barclays Aggregate Bond Index generated an average rate of return of 7.5% with a standard deviation of just 5.5. Stocks, on the other hand, generated less than two times the return (12.7%) for more than 3X the quantifiable risk (standard deviation of 17.4). Bonds contributed to portfolios in a truly incredible way over this period. Sadly, those days are long gone. With the 30 year T-Bond yielding just 3% there is simply no way that the bond market can generate the types of nominal or risk

risk adjusted returns that investors have become accustomed to in these kinds of balanced portfolios like a 60/40 stock/bond portfolio which generated an average annual return of 10.5% over the last 30 years.



We can put this in better perspective by looking at where we've been and trying to project where we might be headed. Over the course of the last 30 years a 60/40 stock/bond portfolio has grown at roughly 10.5%. That's due largely to that 7.5% return from bonds, but also the average 12.6% return in equities. These are both high historical figures. In fact, since 1928 the S&P 500 has averaged a return of 11.76% per year. If we assume that the S&P 500 generates something closer to its historical average return while the bond portion of a portfolio generates a 3% return then the average annual return of the 60/40 portfolio will decline by over 2% to 8.4%.

That doesn't sound so bad except for the fact that you're now generating over 85% of the total return from the inherently more risky portion of the portfolio. Unlike the prior 30 year period where bonds generated a 7.5% return and contributed to 30% of the total return, the future is not only likely to be a period of lower returns, but it's also likely to be a period of more volatile returns because the return stream will be coming from an inherently more volatile asset class.

The Most Important Question

This raises an important question for anyone allocating assets—in order to generate the same types of returns that investors have become accustomed to and in fact might be increasingly dependent on for retirement needs, will they be willing to take the required levels of risk to achieve those returns? After all, if you want to generate that same 10.5% return you now have to be willing to take on more equity market exposure than you've been accustomed to.

The alternative approach is to manage assets differently and go outside of the traditional "passive" indexing approach. In other words, it's ironic that, as passive indexing is growing in popularity, it appears to be riding the wave of what is little more than a massive bull market in bonds and these investors, who regularly demonize "trend chasers", could be chasing the biggest trend of them all.

Based on the high probability of lower future returns, my guess is that the investors who generate the best risk adjusted returns in the coming 30 years will be investors who deviate away from this 60/40 style that has become so popular and instead capture the same low fee and tax efficient approach in differentiated ways. One approach that is likely to generate decent future returns is the risk parity approach which will make up for lower risk and returns in bonds by leveraging these portions of the portfolio, however, in order to achieve that return you have to also be willing to embrace these high fee and leveraged approaches. That might not be an ideal alternative.

Instead, I think we can account for risk across asset classes without the high fees, high leverage and tax inefficiencies that often come with these approaches. We can account for risk in a more cyclical nature. While traditional portfolio theory says that we should rebalance portfolios back to a nominal asset class weighting, this approach ignores the inherent dynamism of the business cycle and market cycles like the one discussed here. Risk parity approaches improve on this model by quantifying the amount of relative risk in asset classes, but fail to account for the cyclical risk in asset classes. That is, they suffer, to large degree, from rear view mirror assumptions much like traditional indexing does.

This, in my view, is where there is room for improvement in these approaches. By taking a cyclical perspective of relative asset class risks we can formulate an asset allocation approach that accounts for where we are in the business cycle as opposed to a static approach that fails to adjust for changing relative risks. After all, we know that asset classes that rise in value tend to become riskier on a relative basis, but we don't rebalance our portfolios to account for the fact that a 50/50 stock/bond portfolio at the beginning of a business cycle is less risky than a 50/50 stock/bond portfolio at the end of the business cycle. We rebalance on a nominal basis, but not a risk adjusted basis. This makes no sense as it pertains to the dynamic nature of risk.

This cyclical approach allows us to be extremely inactive and tax/fee efficient, but it also allows us to alter portfolios to account for the probability of changing relative risks over the course of the business cycle. This increases the odds that we will be overweight risky assets during the expansion phase of the business cycle and underweight risky assets during the contraction phase of the business cycle. The beauty of it is that we are simply rebalancing our portfolios just like we always would, however, we are rebalancing in a more intelligent manner. In doing so we are adhering to the simple understanding that asset classes tend to become riskier as they rise in value, but instead of rebalancing a portfolio late in the cycle back to a nominal asset class percentage we are reweighting the portfolio back to account for the changing risk landscape in relative asset classes.

This, in my opinion, is the future path that investors will be required to take in order to generate satisfactory returns going forward. Low cost differentiated approaches are likely to see increasing demand at a time when a static bond heavy allocation fails to generate satisfactory returns.

The most interesting part is, if you understand that anyone who deviates from global cap weighting is, by definition, an active investor, then we are all active investors. But some active investors will implement smart and high probability based asset allocation programs with low fees and tax efficiencies while others will likely fall victim to the idea that the future is likely to look like the past. And those investors who assume that the next 30 years are likely to look like the last 30 years will very likely generate returns that leave them short of their financial expectations.

For more information about Orcam Financial Group and our products and services please contact us at (858) 220-5383 or via email at info@orcamgroup.com

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