Assuring Your Retirement: What You Need To Know

Thirty years have passed since Gary P. Brinson, CFA, Randolph Hood, and Gilbert L. Beebower (known as BHB in the time since) shook the foundation of the financial investing world by publishing "Determinants of Portfolio Performance," in which they asserted that the variation of asset allocation in a portfolio was responsible for 93.6% of its return, diminishing factors such as stock selection and market timing to a meager 6.4%.

Despite that landmark finding, and its subsequent ability to withstand future challenges from skeptics, the prowess of asset allocation continues to be challenged by the decades-old notion that the only way to truly succeed in financial investing is through the "buy-and-hold" strategy that continues to be the mantra of many a financial advisor regardless of what their clients' needs or goals are.

The buy-and-hold strategy is not without its merit historically, but the evolution of the economic picture of the US in particular and the world in general has caused it to become outdated.

The Golden Era of Buy-and-Hold
Put yourself back in time to the 1950s. World War II has ended, and with it, America is entering a golden age of production - cars, household items, everything a man, wife, and 2.5 kids need to live behind their white picket fence happily ever after. Companies are becoming corporations and building empires - not just focusing on one problem or one product, but expanding across industry lines. Just after the conclusion of the war, Procter and Gamble (PG) has revolutionized the laundry and personal hygiene markets by introducing Tide detergent and Prell shampoo. Over the next 14 years, the company will roll out Crest, the first toothpaste with fluoride; Charmin toilet paper; Downy fabric softener; Head and Shoulders shampoo; and the real bell cow of the mix, Pampers - the first non-cloth diapers. You get in early with PG and ride the tidal wave of momentum that ensues. Holding the stock until it makes no sense not to sell it - when your kids are off to college; when it's time to retire, etc.

Companies like PG and Coca-Cola were early empires in those days, finding market space in product lines that were previously either unexplored or unclaimed, and building their brands across multiple countries. Corporations of that breadth are rarely starting up in the US or abroad in the modern era; companies do best by finding a specific niche and addressing it, hopefully first and best, as competitors and imitators are quick to flock to any market that appears to be turning a profit.

The profile of the average investor has changed dramatically as well. In 1960, the average American was 29 years old and carrying far less debt than his 37.7-year-old 2014 equivalent. Between credit cards, student loans, car payments, and mortgages, the average American household currently carries $130,000 in debt. This debt burden makes it critical that an investor not suffer large losses of principal.

Asset Allocation's Answer
Because the corporations that conquered multiple markets in days gone by now have slower growth rates, the smart investing strategy becomes to craft a portfolio that is your own

personal multi-pronged corporation. Mixing exchange traded funds (ETFs) and other financial resources across multiple industries, types of commodities, etc. gives you the freedom to be aggressive with some investments, conservative with others, and perhaps most importantly, avoid putting all of your proverbial eggs in one basket by largely eliminating single-stock risk. The financial world has changed irrevocably with the onslaught of digital technology, making investing a real-time, international affair. A carefully selected portfolio allows you to balance knowns with unknowns, domestic with international, tech sectors with established products, etc. This balance requires active participation by a trusted advisor, which is by definition the polar opposite of buy-and-hold, known the world over as a passive investment strategy.

The Modern-Day Flaws of Buy-and-Hold

Proponents of the buy-and-hold strategy will often point to its past success, which is undeniable, but also immensely short-sighted. Predicting future success based on past performance is the kind of blind logic that caused the NASDAQ, dot-com, real estate, and credit bubbles of the past 20+ years. There's no doubt that many markets move in cyclical patterns, but economics themselves have clearly evolved past the point of new start-up, multi-industry corporations that can be relied upon to stand the test of time and make sound, long-term investments.

Even the modern-day tech giants cannot be relied upon for steady growth. Consider the case of Cisco Systems (CSCO), known the world over as the 'plumbing of the Internet.' In 2000, CSCO was humming along at $81.75/share at the peak of the dotcom bubble. A little more than two years later, it had imploded, falling to $8.12 a share in October of 2002.

Buy-and-hold investors could have easily decided to stick it out, reasonably predicting that the Internet was a fixture of the present and future worlds, and that statement was correct, but CSCO has never even sniffed that high-water mark again. Sixteen years after its peak, it's trading at $28/share.

That sort of behavior is a staple of the S&P 500, which is where most buy-and-hold strategies come from. Bear markets, categorized by periods where the S&P 500 falls by at least 20% in value, occurred 15 times in the 80-year span between the crash of 1929 and the Great Recession of the last decade.

On average, it has taken the market 3.9 years to return to a break-even position, which means a buy-and-hold investor is not losing just money, but time, the true irreplaceable commodity. What's worse is that there is another bear market an average of every five years after the last, meaning the theoretical buy-and-hold investor would have about a year to start building up earnings following one recovery period before plunging down into another valley.

There are some investors out there who believe that they have "good stocks" and their strategy should be to simply "grit their teeth" and they'll be able to hold on and survive through a bear market. Unfortunately, the odds are decidedly against that idea; statistics show that in a bear market, just 3-6% of equities are able to swim upstream against the current. In other words, if you're feeling really lucky, go ahead, but it's not a smart bet.

Andrew Lo, director of MIT's Laboratory for Financial Engineering, put it as bluntly as possible in a *Money Magazine* interview:

“Buy and hold doesn’t work anymore. The volatility is too significant. Almost any asset can suddenly become much more risky. Buying into a mutual fund and holding it for 10 years is no longer going to deliver the same kind of expected return that we saw over the course of the last seven decades, simply because of the nature of financial markets and how complex it’s gotten.”

Lo isn’t the only leading economist preaching the unreliability of stocks, either. Yale University’s Dr. Robert Shiller, creator of the cyclically adjusted price-to-earnings (CAPE) ratio, warns of diminished returns in the next decade, based on prices divided by 10-year average earnings.

Warning of retracements for the Dow Jones and S&P 500 of as much as 30 percent, Shiller said, “"Nobody can really forecast the market accurately. But I think this is a risky time." The uncertainty does not just stop at the edge of the United States’ borders, either. Macroeconomic conditions the world over make the buy-and-hold policy a risky one.

According to the World Bank, global growth continues to head in the wrong direction. "More than 40 percent of the world’s poor live in the developing countries where growth slowed in 2015," said World Bank Group President Jim Yong Kim.

A lack of steady growth and fractures in countries whose economies have been traditionally strong makes any sort of long-term investing risky at best. A weakened US economy has ramifications all over the world because of its many trade partners and allies.

China has grown at a breath-taking clip (although that is starting to weaken) and with that growth is accumulating its own massive amounts of debt. No country in world history with a debt build-up as large and rapid as China’s has ever experienced a soft landing. The country is already seeing signs of growing pains as its rural and urban populations veer in different directions with different wants and needs. China also holds 7.2% of the current US debt, the most of any foreign country.

While the 28-country European Union (EU) is ostensibly powerful due to the idea of strength in numbers, the EU is only as strong as its weakest link, in this case the debt crisis that has plagued it since 2009 due to the inability of Greece, Cyprus, Portugal, Spain, and Ireland to pay off debts or refinance them without the assistance of third parties. The debt crisis is a three-prong problem, consisting of debt, deflation, and demographics. Greece and Spain have been the most odious of the offenders, with Greece’s debt reaching 179% of its GDP in 2014, while Spain’s total debts have passed the €1 trillion-mark.

Even in markets like oil where long-term demand is all but guaranteed, the possibility of upheaval and massive fluctuations is a risk, as was seen in the so-called Arab Spring of 2010 as the leaders of Egypt, Libya, Tunisia, and Yemen, were all ousted, and sweeping changes and reform were demanded in countless other Middle Eastern countries that are part of the oil supply complex. Oil is a precious commodity, but also a fickle one. The price of one barrel of oil was $110 in 2014, then plunged to $26 in 2016. In addition to death and damage to property and infrastructure, the Arab Spring was followed by an ‘Arab Winter’ that saw the Arab League suffer considerable economic downturn.

Likewise, natural disasters can cripple even the strongest of economies, as has been brutally evidenced in Japan by the combined earthquake and tsunami that caused the catastrophe at the Fukushima Nuclear Plant in 2011. One of the world's largest economies before the incident, and still owning 7.0% of the US' national debt, Japan has been forced to import 90% of its energy needs after the disaster, with an estimate of some $250-500 billion in economic losses in the time span since, with the potential for even more huge losses ahead, as the reactor and surrounding nuclear storage facilities are still not completely safe and secured. Japan has experienced suboptimal growth ever since 1989 despite a series of governmental stimulus attempts including monetary expansion and negative interest rates.

Understanding Asset Allocation
While asset allocation is the far superior method of investing to buy-and-hold, it is not without its own set of obstacles to avoid, most notably the massive amount of misinformation that surrounds a study that has been part of the financial investing vernacular for three decades.

The BHB study in 1986 took a closer look at the quarterly returns of 91 US pension funds between 1974-1983, and compared those results to a hypothetical fund of indexed investments over that period of time. Their conclusion, as previously stated, was that asset allocation explained 93.6% of variation in a portfolio's quarterly returns.

Brinson, Hood, and Brian D. Singer provided a follow-up five years later, examining the returns between 1977-1987, and found the variance at 91.5%, which for most was iron-clad proof of their original claim. The fact that stock picking was responsible for less than 9% of returns is perhaps one reason for the growing popularity of Exchanged Traded Funds (ETFs).

However, what continues to be lost in the shuffle over the past 30 years, is that asset allocation does not afford its user a return of 93.6% any more than wearing a tuxedo and drinking martinis makes you into James Bond. It does mean that overwhelmingly more than any other factor, the way an investor spreads his money around in key assets determines how successful or unsuccessful he is in the long run.

The simple logic of asset allocation versus buy-and-hold is easy to follow. Buy-and-hold requires a long-term commitment to stocks with the tenuous plan to ride out any and all market fluctuations until an expiration date, at which point the portfolio will be sold. But the variables in that equation are almost too many to count.

What happens if the stocks go into a dive?

What reasons, if any, are acceptable for selling early?

What happens if the market has a crash like it did in 2008-2009, when it's time for you to cash out or need to pay unexpected expenses?

Pie Chart Investing
The prescribed asset allocation strategy from most investment advisors is little better than the buy-and-hold technique, particularly when you consider that it forces you to adhere

strictly to a single theory rather than devise a plan of attack based on current, short-term, and long-term financial conditions. Static asset allocation calls for portfolios of a broadly diversified nature, but insists that you devote certain percentages of your portfolio to certain types of assets, regardless of whether or not those markets are strong, weak, or anywhere in between. The fact of the matter is that this sort of allocation guarantees lower returns. By following this rigid rule, you are forcing yourself to invest in areas that are not your first choice simply because they fall into the given parameters of the pie chart. If you're a fan of the NFL, imagine being the general manager of your favorite team. You know that the SEC produces the most NFL players every year, so you decide to use 60% of your picks on SEC players. But in doing so, you pass up prospects from other conferences who are better overall talent, solely because your draft strategy tells you to. Does that make any sense?

Exactly how your assets are allocated is a plan drawn up by you and a journeyman advisor based on what your goals for your portfolio are as well as other factors like your age. What you get is a mix of short- and long-term investments of different asset classes. This is "pie chart" investing, and simply put, it produces mediocre results in the long term.

Risk-Adjusted Asset Allocation

So if not buy-and-hold and not static asset allocation, what is the answer? The answer is building a better mousetrap, which in the realm of financial investing means knowing your goals and knowing when it's time to get help. A trusted advisor can guide you to invest in the right blend of ETFs based not on a statistical theory, but on the real, hard facts of modern economics and finance. This sort of experience is not always easy to find, as there is an entire legion of advisors out there who do things only by the book because it is the quickest way towards getting their quotas and churning through the highest volume of clients possible. This cookie-cutter approach, generated by Wall Street, appeals to the lowest common denominator when it comes to financial advisors. Do you really want that sort of person in charge of your money? The advisor you seek is one who has the background and experience to make judgement calls on risk, optimal holdings, and indicators of what will happen in the short, medium, and long term.

Your advisor will be able to balance risks and rewards by sector, putting your money into the best ETFs and exit or rotate your cash when conditions such as economic, monetary, or valuation tilt that risk-reward equation to the negative.

A primer of the main factors involved is below, but realize that only a true expert in the field, someone who devotes their waking hours to comprehending the rollercoaster rides and obstacle courses that make up financial investing, can give you the guidance necessary to secure your financial future.

Points of consideration:

<u>Valuation of Stock:</u> A stock price rising rapidly can have everything to do with its valuation or absolutely nothing. More than a few poor souls have seen their fortunes evaporate as they ride a rocket with no parachute. Valuation refers to the company behind the stock's actual worth in the current economy - usually based on things like the market value of its assets, its capacity for future earnings, how its capital is structured, and what the management team looks like.

Economic Growth Rates: A percentage change based on a country's increase in Gross Domestic Product (GDP) from one year to the next, with inflation adjusted. Comparing a country's growth rate to its international competitors as well as the world as a whole is an excellent starting point. Do the country's demographics support or hinder long-term economic growth?

Debt Structure: The structure of debt for any entity encompasses how its principal and interest payments are scheduled in terms of duration and frequency. The original repayment terms and any additional provisions are included here, as well as how much margin of safety exists for shareholders. Sovereign debt must be evaluated based on the underlying economy's ability to service the load.

State of Interest Rates: A key indicator of the current and future state of the financial world, interest rates directly reflect banks' and other lenders' confidence in the ability of borrowers to pay back loans. They can be tricky to interpret, however, as falling interest rates can actually be a negative deflationary sign. As more central banks move towards negative interest rates (NIRP), the situation becomes dicier.

Investor Sentiment: This is one of the toughest areas to ascertain correctly, as it involves human emotion rather than cold, hard facts and can be completely at loggerheads with the fundamentals of the marketplace. Fortunately, quantitative tools exist to define and measure actionable sentiment extremes. Sentiment is often akin to crowd psychology, which reveals itself with price movement and level of activity for a certain market. Generally speaking, when sentiment is too lopsided, beware of an impending reversal.

Currency Trends: Currency movements are discounting the future and often respond most dramatically to unexpected news, be it political or economic. An understanding of currency trends is critical to tempering risk levels in portfolio construction.

Inflation Trends: Most of us have ingrained in our head that inflation is a bad thing, and while that may be true to us as consumers, the same logic may not hold when we approach inflation trends from an investment standpoint. Central banks try to control inflation and deflation to keep economies running smoothly, a situation that can backfire and create opportunity in real-asset sectors.

Geopolitical Risks: Political changes from election results all the way up to the possibility of military coups and civil conflicts are very much a real factor in how to build and manage an optimal investment portfolio. The longer the timeline on an investment, the larger these can loom as countries are likely to undergo significant change in the longer haul.

True Available Liquidity: True liquidity and credit can be dramatically different. Central banks create credit, whereas liquidity arises from commercial enterprise. If you take out a $1 million loan, you may be temporarily liquid but nevertheless balance-sheet broke. Governments default on a regular basis, Argentina being one example of such. Financial market declines reduce liquidity and therefore can enter self-reinforcing downward vortexes from time to time.

Central Bank Policies: Like geopolitical trends, these can vary dramatically from country to country. Central banks are in charge of maintaining a country's economy by controlling its currency and inflation, while also printing money and acting as a last-resort lender against economic collapse. Geopolitical factors weigh heavily on central bank policies. Central bank actions can control markets in the short term, but in the final analysis, markets take charge. Central banks often exacerbate economic problems with their "fixes".

CONCLUSION

BHB's breakthrough study of three decades ago that drove the American investor away from buy-and-hold and towards asset allocation was a revolutionary process for individual financial investing. However, those 30 years have necessitated that asset allocation evolve along with the ever-changing economic landscape. Pie chart investing, also known as standard asset allocation, cannot give anything better than mediocre rates of return, as the markets both domestically and globally are constantly changing, with consistency truly a thing of the past. Risk-adjusted asset allocation, done through the careful advisement and input of a seasoned financial advisor, is the optimal investment strategy capable of handling these rapid-fire changes in economic conditions, keeping you in a position to build your wealth, be as flexible as the environment calls for, and be able to rotate or exit portions of your money without taking excessive and uncontrollable risks.

KEY TAKE-AWAY

Buy-and-hold is broken. Static allocation doesn't work, in fact it's the sure road to sub-par results. To survive this game, we believe the only well-reasoned answer is risk-adjusted asset allocation with the help of an educated financial advisor.