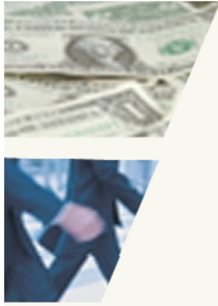

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The Steward

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Markets Causing You to Lose Sleep?

The state of the capital markets may have you up nights worrying about the health and security of your organization's investment portfolio. The housing crisis has deepened, volatility in the equity markets has soared, and a massive government rescue program appears imminent. However, this is not the first nor will it be the last time that we will experience a low probability, but high consequence "fat tail" event. The Savings and Loan (S&L) crisis in the 1980's, the 1987 market crash, the 1997 Asian financial crisis, the bursting of the tech bubble in 2000 and the attacks of September 11, 2001 are a few examples from the past 30 years. Through all of this, the financial system has proven remarkably resilient and adaptable.

What to do? The Panic-Proof Portfolio

The resiliency of the financial system, however, was not without periods of significant loss in the equity markets. From 1926 – 2008, the S&P 500 Index reached bear market territory (20% or more below its high) seven times. On average, bear markets came 11.8 years apart and lasted 4.8 years. It is only a matter of time before market conditions cause panic for insufficiently diversified investors. Knowledgeable investors knew the current lousy equity environment was possible (if not probable) when they constructed a "panic-proof portfolio" (a well diversified strategic asset allocation) over the last several years. Knowing that bear markets will arrive and stick around for considerable periods of time, investors should construct their portfolios in a manner that smoothes the ride over all market surfaces.

Portfolio Pistons

The more pistons in a car's engine, the more smoothly it rides. The same concept applies to asset allocation. The more a portfolio is diversified among low correlating asset classes, the better the long-term expected risk-adjusted returns. However, correlation among global equities often rises during periods of stress. Therefore, a panic-proof portfolio must include other real and alternative assets that maintain their low or even falling correlations when the domestic equity market is under attack.

Asset classes such as Treasury Inflation-Protected Securities (TIPS), unhedged international bonds, commodity futures, multi-strategy fund of hedge funds and Energy Infrastructure master limited partnerships (MLPs) have enjoyed low historical correlations to U.S. equities. When combined with more traditional asset classes, a panic-proof portfolio provides a significant amount of downside protection. Diversification that lessens losses during bear attacks not only mitigates panic, but can also increase long-term returns. The best way to make money is not to lose it in the first place.

One of the first questions posed to investment advisors by clients during bear markets and periods of great uncertainty is, “What should we change?” Reactively shifting investment strategy during or immediately after periods of turmoil is often a recipe for disaster. By “timing the market” the investor is highly likely to miss the best gains. By adopting a panic-proof portfolio, the urge to change strategy is lessened, downside losses are moderated and one finds themselves more rested after a good night of sleep.

For more information on the panic-proof portfolio, please read our recent white paper “The Panic-Proof Portfolio” at www.dimeoschneider.com.