10/6/2015

Time Horizon and Investment Risk

Global financial markets experienced a brutal third quarter in 2015, with both equity and credit markets posting considerable losses. US large cap stocks lost 5.9% in Q3 amid declining corporate earnings, while US high yield bonds lost almost 5%. International markets fared even worse, with developed international stock markets losing 10.3%, and emerging market stocks losing 17.8%. The dollar continued its rise, gaining 4.7% during the quarter, as fears of slowing EM economic growth and expectations of higher US interest rates caused investors to seek safety in the greenback. The rising dollar and slowing global demand continued to pressure commodities: oil prices declined by 24% during the quarter.

While recent financial market volatility and losses have been unremarkable by historic standards (the recent high/low correction of 12.4% in the S&P 500 is less than the 35 year AVERAGE annual intra-year correction of 14.2%), the downturn has perhaps been felt more acutely on the heels of the low volatility of recent years. Until late August, the S&P 500 had gone almost four years without even a 10% correction.

As markets experience inevitable periods of volatility and losses, investors become understandably concerned about whether they will be able to meet their long-term financial objectives. We regularly stress the importance of the key elements of a successful long-term investment plan, and feel that the current environment is an appropriate time to do so again.

SFA believes that for a long-term investment strategy to be successful, it must involve a disciplined and repeatable investment process, be cost efficient, and incorporate an appropriate amount of risk for the financial circumstances, time horizon, and comfort level of the client.

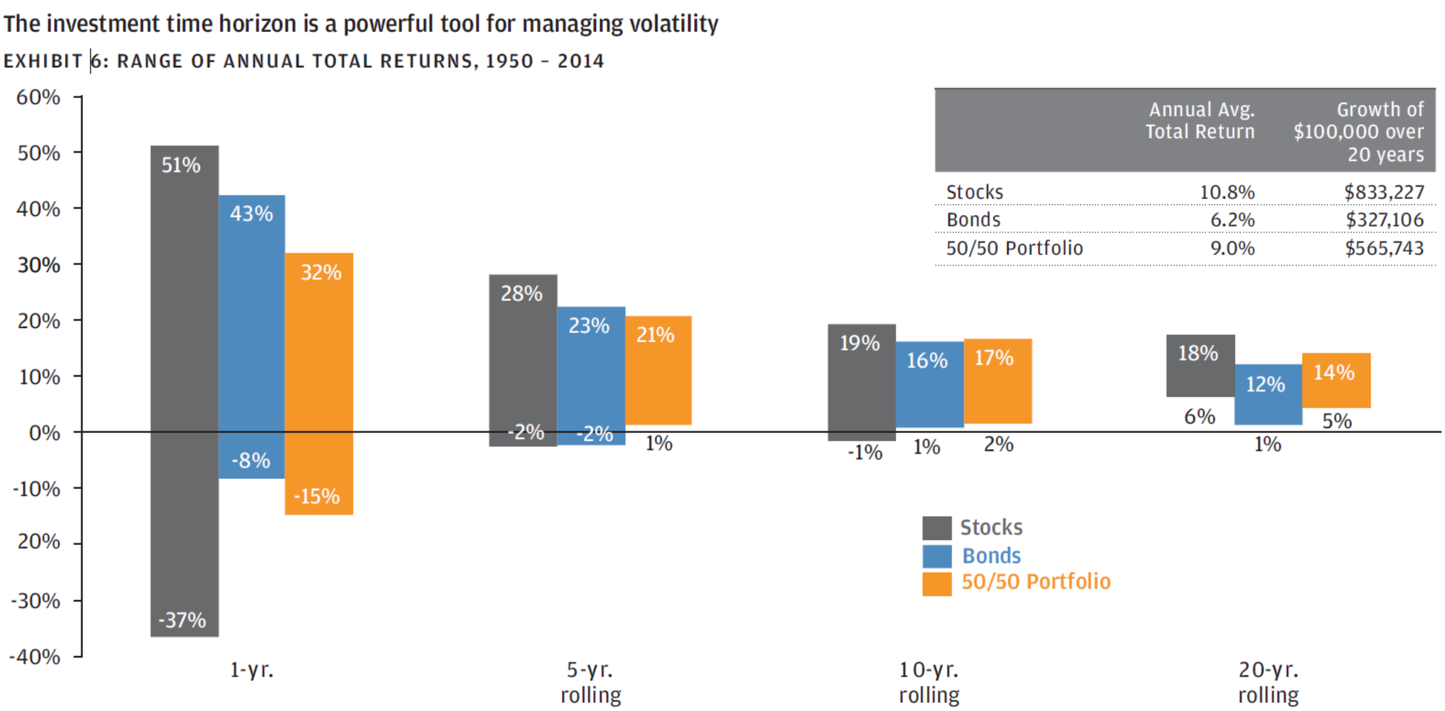
At the recent SFA Investor Roundtable, we discussed the importance of aligning an investment strategy with clients' time horizons. Not only is investment time horizon an important element of a well-crafted investment strategy, we can also view it as another way to think about investment risk.

Just as the construction of diversified portfolios represents an opportunity to improve the overall investment risk/return proposition, investment risk should also be viewed in the context of its time horizon. A given portfolio strategy will generally have a much narrower range of likely outcomes (and therefore potential for loss) over a long time horizon than a short one, given the tendency of market returns to mean-revert. This has two important implications: first, the importance of properly aligning an investor's portfolio risk with his/her time horizon; and second, the importance of maintaining a consistent investment strategy over as long time period as possible.

While it would be foolish to take any material investment risk with funds that are earmarked for a specific purpose within a short time-frame, most of our clients have a 10+ year investment horizon, over which they require their assets to grow in order to meet their financial objectives. Exhibit 1 illustrates the historic volatility of three investment portfolios (all stock, all bond, and 50/50 stock/bond) over 1, 5, 10, and 20 year rolling periods going back to 1950. The graph illustrates that while all the three portfolios have exhibited great return volatility over short time frames (in the worst year stocks lost 37%, and the mixed portfolio lost 15%), over longer time periods losses became increasingly unlikely. For example, since 1950 the 50/50 portfolio never experienced a 5 year loss; even the 100% stock portfolio never averaged less than a 6% annual return over any 20 year period within that time frame.

The lesson is clear: in order to achieve their long-term financial objectives, investors should implement an investment strategy consistent with their risk tolerance and time horizon, and then stick with it throughout market cycles (other than adjustments that may be required for changes in personal circumstances). It is imperative to avoid the temptation to increase risk after periods of rising asset prices, or to decrease risk after (or during) periods of falling prices.

Exhibit 1 – Managing Portfolio Volatility slide



Source: Barclays Capital, FactSet, Robert Shiller, Strategas/Ibbotson, Federal Reserve, J.P. Morgan Asset Management. Returns shown are based on calendar year returns from 1950 to 2014. For illustrative purposes only. Growth of $100,000 is based on annual average total returns from 1950 to 2014. *Guide to the Markets* – U.S. Data are as of 1/31/2015.

Discussion of Our Most Recent Tactical Change

While we take a long-term view of investment strategy, we are always evaluating a variety of investment markets to identify those that we think are either unduly expensive (and to be avoided) or highly attractive. During the third quarter market correction, we made no tactical changes to our client portfolios. As we have previously advised our clients, we have for the past several quarters maintained portfolio risk below our neutral strategic position, and have been therefore quite comfortable with our positioning. However, the recent moves have made valuations in several sectors more attractive (or less unattractive in certain cases); as a result we have been monitoring markets for a chance to add risk at favorable levels.

One sector that has cheapened considerably in recent months is the US high yield bond market. As most investors know, high yield bonds, which are rated below "investment grade" by rating agencies, expose investors to a higher risk of default than investment grade bonds. Thus, an assessment of the attractiveness of high yield bonds must focus on the incremental yield (or "spread") that the securities pay relative to investment grade bonds: this spread represents the compensation that investors receive for accepting default risk.

From the beginning of June until early October, high yield bond prices declined significantly as fears of slower economic growth, lower oil prices, and potential illiquidity unnerved investors. Over that time, yields on the Barclays US High Yield Index went from less than 6% to over 8%, though yields on comparable maturity US Treasury securities actually declined. As a result, the spread (additional yield) offered by HY bonds rose from about 4% in early June to a current level of over 6% (see Exhibit 2). This occurred even though HY bond issuer defaults have not materially increased, and are currently running close to 2% annually, well below their long-term average of 3.6%. Assuming the historic average loss upon default of roughly 75%, at the current HY default rate we would expect approximately 1.5% in default losses per year.

While defaults could certainly rise, SFA believes that the current annual additional yield of 6% is more than adequate compensation for this risk, and as a result we believe that HY bonds have recently become attractive. Consequently, we are implementing a tactical change in our portfolios this week, adding exposure to the sector. We may increase our allocation further should we see even more attractive prices.

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Exhibit 2 – Barclays AGG HY bond spreads

Source: Bloomberg, LP

We greatly appreciate your business and support. Please don't hesitate to contact any member of the SFA team for a review of our current thinking, or a review of the appropriateness of your portfolio's risk profile.

David Marion, CFA®
Partner and CEO
Santa Fe Advisors, LLC

Disclosures

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