HEARD FROM CLIENTS

HOW CAN WE PREPARE OUR INVESTMENTS FOR THE NEXT MARKET CORRECTION AND IMPENDING VOLATILITY?

In our previous commentary, we shared our thoughts on how to handle the emotional side of downside risk, market volatility and market corrections. Most of our clients leave this conversation reminded of the portfolio protections they already have in place, realizing that they will likely be able to weather a downturn. Some families, however, want to explore additional options to protect against an inevitable downturn, the cost of doing these options, and even how to potentially capitalize should a market correction occur. We discuss some potential issues below.

FIRST

Selling everything and going to cash is generally a suboptimal investment decision. There is an old Wall Street saying that the market can remain irrational longer than you can remain solvent. Many great investors have been humbled by acting too early, even if they were ultimately proven correct. Many great books on managing wealth for the long term explore this lesson. Timing the market is very difficult; thus, we encourage our clients to act when valuations are what we consider to be extreme, that is, around two standard deviations from the long-term average. When we develop a strategic allocation for our clients, each asset class or strategy has a target allocation and a range above and below the target. When valuations are at relatively high levels, we recommend that clients reduce exposures to the lower end of the appropriate range. We would likely only recommend that clients exit an asset class entirely when they would probably not be rewarded for taking risk in that asset class and that they may, in fact, stand to lose substantial value if they remained in that asset class.

SECOND

If reducing exposure is warranted, we recommend starting by selling the “easy things,” which we generally identify as the riskiest of an investor’s liquid assets. Ideally, these sales should be part of a general rebalancing plan. Systematic and intelligent rebalancing is one of the better

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practices an investor can establish and maintain. Outside of regular rebalancing, investors might consider reducing exposures to the most liquid of the riskier asset classes that are most overvalued. Downside volatility in previous market corrections may also be an indicator of assets to potentially sell, but history does not always repeat itself. Current examples of relatively more risky asset classes are domestic equities, international equities, emerging markets equities, high yield fixed income and REITS. Taxable investors should consider the tax friction of any sale before taking action. For positions with a long holding period, chances are good that a portion of your sales will result in realized gains, which may be taxed. Even with today's relatively low capital gains rates, the tax friction can be material, depending on the relevant state and country of residence and how highly appreciated the positions are. Investors can typically can find some positions in a portfolio to sell with minimal tax friction. It may take some time to ferret out the relatively new positions or specific tax loss from an older position, but the search is worth the effort if you can sell riskier assets with minimal friction.

THIRD

If tax friction or other limitations prevents selling assets, consider a hedging program. We have explored both the purchase of out-of-the-money ("OTM") put options and "cashless collars" (where OTM call options are sold to fund the purchase of OTM put options with minimal cash required to establish the position). The tax rules involved with such positions can be complex, so consulting your tax advisor is a necessary step when considering establishing a hedging program.

Both of these strategies have positive and negatives aspects. OTM put strategies can provide downside protection, but only for a limited amount of time (the term of the put option). Additionally, depending on the length of term and how close the strike price is to the stock's current price, these options can be expensive. "Cashless collars" are often considered more attractive by clients because the cash out of pocket at the inception date can be minimal. But, investors must remember that they may lose out on the appreciation of the position above the call option's strike price. In our experience, clients like having downside protection but are less willing to give up the upside. Regardless, we have found that evaluating these types of hedging strategies is always informative, and clients generally find them useful.

Related to hedging strategies, another way to achieve downside protection is to add noncorrelated or negatively correlated assets to the portfolio. For example, to protect against rising interest rates, we might add an investment strategy to portfolios which would do well if rates rose. Were we to do this today, we might employ a rather complex strategy that would act like an ordinary corporate bond yielding ~3% but would return ~15% if the 10-year U.S. T-note's yield increased by 1% over a one-year period. The downside risk is that if rates on the 10-year U.S. T-note fell, the client's return could be slightly negative. A small amount of this strategy in the portfolio could provide an outsized return offset to rising rates, thus allaying the fears of families regarding the fixed income portion of their portfolios. If, on the other hand, rates were to decline, we would expect that the slightly negative return of this strategy would be more than offset by the increase in the overall value of the bond portion of our clients' portfolios. And, if rates remained relatively unchanged, this asset would provide a yield roughly equivalent to the current return on the bond portion of their portfolios.

Accepting market downside risk is a necessary part of being a long-term investor. Without downside risk, there is theoretically no upside reward. We do not believe that riskless arbitrage opportunities exist, and if they do, they only exist for short periods of time. The key is for families to understand and accept the right amount of risk and then stick to the plan, reducing risk as market valuations increase to what we believe to be historically high levels and by increasing risk when market valuations are what we believe to be historically low levels.

It's worth saying again and again that the investors who get hurt the most in a market correction are usually the ones who hold on the entire way down and then panic only to sell at the bottom. We've found that by walking families through the actions we would take if markets were to decline or by looking at available protective actions that can be taken before a downturn, families are better prepared because they understand and accept market risks better than those who have not gone through such exercises. In the end, we feel that prior evaluation and preparation for what clients should do in a downturn is the ultimate portfolio protection plan.

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