Risks Remain: Are You Prepared? (Part III)

Markets Have Rebounded

Equities recovered nicely in the first quarter with the S&P 500 ending up 13.6% and the Russell 2000 small cap index returning 14.5%. The International MSCI-EAFE and MSCI Emerging Market indices were both up in the 10% range. The Equity Hedge Index (HFRI) posted a 7.2% return. In fact, nearly every equity index was positive for the first quarter of 2019.

Also, annualized 10-year returns for equities look fantastic: US equities were up in the 16-17% range and international indices exceeded 9%.

On the other hand, bond performance for the same 10-year period was modest at best. The annualized 10-year return for the Bloomberg Barclays US Aggregate Bond index was 3.8% and the Bank of America 1-3 Treasury index was a meager 1.04%. With zero or negative yields on high quality European and Japanese sovereign bonds during this period, international investors' demand for US Treasuries dampened US bond returns and financed our federal debt.

We're Back to Normal, Right?

With equity markets continuing their positive surge, you may be scratching your head and thinking, "where's all the risk everyone is talking about?"

How quickly we have forgotten that the market took a precipitous drop during the fourth quarter of last year and that most of the major indices have yet to return to their 2018 peak. If you had invested at the top of the market in late September, your portfolio would likely still be down.

It is also important to note that the current 10-year stock market numbers do not include the gut-wrenching downslide period of the Financial Crisis which bottomed on March 9, 2009. Except for the brief but volatile periods of decline in 2011 and 2018, the US stock market has gone steadily up since then. And, during most of the same 10-year period, bond returns were artificially held in check because of the Fed's firm hand in lowering interest rates. It is unlikely that the near future will see such smooth sailing. The volatility that marked the end of a remarkable decade is likely a harbinger of choppy waters ahead.

Which leads us to remind you that **volatility matters**. The more you lose, the higher the percent recovery you need to get back to even. If you lose 20% (as you may have in the 4th quarter of last year), you would need a 25% return to get back to where you started. If you lose 50% (as you may have during the Financial Crisis), you would need a 100% return just to get back to even. The trick to a faster recovery is to lose less when the market goes down!

Interestingly, bonds contributed positively to the recent recovery. While stocks were negative in Q4 2018, the Bloomberg Barclays Aggregate US Bond Index was up 1.64%. And surprisingly, while we might have expected bonds to go down because of their usual negative correlation to

equities, bonds were up an impressive 2.94% in the first quarter of 2019. In part, the good showing by bonds may have been due to the Fed's decision to hold off on scheduled rate hikes. But more likely, stronger bond returns signaled that cautious investors spooked by the stock market continued to seek safety in high quality bonds globally.

Risks Remain – Trade, Politics, Debt
The risks we discussed last quarter remain. During a recent *60 Minutes* interview, Fed chairman Powell acknowledged that though the US economy is doing well, global risks could have a significant negative impact on the US economy. Prominent among these risks are trade disputes and threats to longstanding agreements as well as the political uncertainty surrounding Brexit. Of additional concern is the fact that central banks across the globe, including the US, have been willing to take on record levels of debt to cover deficit spending. Furthermore, investors should be wary of the alarming rise of the US budget deficit, US treasury debt, as well as corporate and private debt here at home.

While economic conditions are currently healthy, most economists predict a slowdown in the US and other developed market economies this year. In January, when the Fed indicated that it would "be patient" and would likely cease raising rates for the remainder of 2019, the equity markets applauded the about-face. However, the Fed's stance could reflect concern that the economy is weakening and would not be able to absorb further rate increases. Another concern is that low short-term rates limit the Fed's effectiveness in managing a recession should a downturn be lurking in the wings.

Understanding Risks and Rewards
Given the increased uncertainty in this late market cycle, an investor might want to ask, "Will I get paid for the risk I am taking?"

Most investors accept that an investment with a higher expected return will also come with more risk, meaning greater volatility and potential for loss. Understanding how an investment has reacted historically in past recessions is important because investors are more likely to panic and make mistakes when losses are more severe than they expected. (Remember the S&P 500 declined more than 50% during the Financial Crisis and the Tech Bust.)

Let's examine what this means to the risk/return proposition offered by the current market.

With growth slowing globally, returns are expected to be muted and risks higher, raising the questions, "Will you get paid for the risk you take?" and "Do you have time to recover from a downturn?" Dialing down the risk in your portfolio may mean giving up some upside, but if the upside (reward) is muted, it might be worth the cost.

Should a financial hurricane be looming, longer-term, high-quality bonds may add protection. Long-term US Treasuries were up 37% during the Tech Bust and 25% during the Financial Crisis, helping to dampen risk by offsetting the massive losses posted by equities. The benefits of these bonds may be less than they have been in the past because interest rates are starting at a lower point.

How Can Bonds Help?
The answer begins with understanding correlation – how the returns of two investments such as equities and bonds move in relation to each other. Ideally, you want to construct a portfolio that pairs investments in a manner that reduces risk (volatility).

Investment returns can relate to each other in three ways. They can move together (positive correlation), they can move in opposite directions (negative correlation), or their movement is not related (correlation = 0). The correlation between two investments can also change over time due to investor sentiment (fear, ebullience), economic conditions, technological changes, geopolitical events, etc.

To build a portfolio that can survive a financial meltdown, you would offset the potential downside risk of your equities with assets that move in the **opposite direction** – such as high quality long-term bonds. Here's how it works:

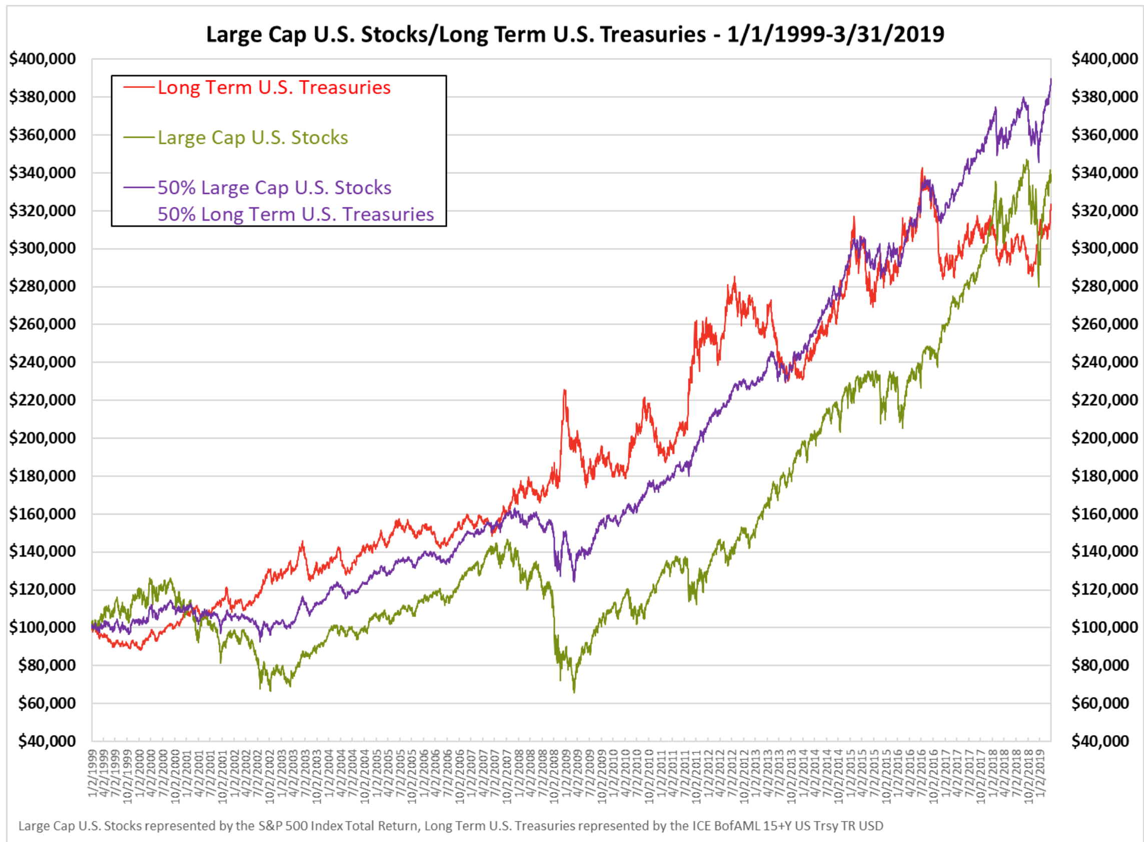
Assume you are holding a hypothetical $1,000,000 portfolio of 50% stocks and 50% high quality long-term bonds. The stocks go down 50%, the bonds go up 25%.

	Initial Value	**Change in Value**	**Final Value**	**Performance During Equity Downturn**
Stocks	500,000	- 250,000	250,000	- 50.0%
Bonds	500,000	+ 125,000	625,000	+ 25.0%
50/50 Portfolio	**1,000,000**	**- 125,000**	**875,000**	**- 12.5%**

In this example, the portfolio loss is $125,000 or -12.5% because the bonds are negatively correlated to equities and offset much of the loss. The 50% decline in stocks would need a 100% return to get back to even. A blended portfolio with a loss of 12.5% only requires a return of 14.3% to get back to even.

Which Bonds are the Most Reliable?
High quality long-term bonds provide high negative correlation to equities and therefore can provide good portfolio protection in times of stress in the stock market. While high quality corporate and municipal bonds have performed well in some past environments, their risk level is slightly higher than US Treasuries which have been a reliable source of negative correlation to equities in periods of high volatility.

To demonstrate how successful pairing equities and US Treasuries can be, the graph below shows the growth of $100,000 starting on January 1, 1999, before the Tech Bust using three different strategies: 100% S&P 500, 100% Long-term US Treasuries, and 50% S&P500/50% US Long-term Treasuries. As you can see the 50% S&P 500/50% Long-term US Treasuries portfolio outperformed the S&P 500 and had the highest return over this time period. Interestingly, Long-term US Treasuries alone tracked ahead of the S&P 500 for 16.5 years.



Source: Morningstar, Waypoint Advisors. Past performance is not indicative of future results. Fees are not included.

Remember: Volatility matters and correlation counts! If you lose less, you don't have to earn as much to recover. And, in times of stress, quality makes a difference!

We leave you with three things to think about:

1) Financial storms, like hurricanes, are unpredictable and it is best to prepare when things are going well, and the sun is shining.
2) Currently there are uncertainties in the markets that could cause a disruption. You should re-evaluate how comfortable you are with risk and take precautions if necessary.
3) Taking less risk in your portfolio may provide as good or even better results with less heartburn. If you haven't done so already, now is a good time to revisit how your assets are allocated.

Wishing you all "fair skies and following seas."