New Frontier

Why isn't all of my money in the S&P?

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Question: U. S. Equity markets are up. Why isn't all of my money in the S&P 500? Why do I have any exposure to treasuries when everybody knows they are underperforming U. S. equities?

At the heart of New Frontier's investment policy is planning for all contingencies and reducing portfolio risk. It may be fashionable to bet strongly on particular outcomes, but a sensible long-term investor needs to prepare for the entire range of plausible outcomes. Some of the assets in a strategic portfolio have higher risks and returns, such as the recently outperforming U. S. equities. However, an important piece of risk management is balancing diverse risky assets having low correlations with one another. Various fixed-income assets, international securities, and alternative asset classes complement U.S. equities in strategic portfolios, since the low correlations between them ensure that losses in one area will tend to be compensated by gains in another.

Risk management matters most of all for long-term investing. The greater the single-period risk, all else equal, the lower the long-term terminal wealth. The longer the investment term, the more certain it is that risky portfolios will be "dinged" by strongly negative returns, and that performance will suffer. On top of careful asset selection, risk reduction happens primarily through diversification.

Long-term investors should never be all in any one asset, asset class, or factor, because overly concentrated portfolios are too risky. Unexpected news stories can rapidly turn markets upside down, and investors who wait for news reports are always too late in this age of algorithmic trading and better access for larger players. Protective exposure to a diversified assortment of assets and risk factors is a better strategy. While particular market outcomes or trends may be foreseeable and even inevitable over time, overexposure to risky assets is a directional bet on market performance, and is only appropriate for tactical investing, not strategic. Tactical investors would require a great and sustained degree of skill to outperform (at any given risk level) a competently constructed globally diversified strategic portfolio like New Frontier's GSAA products over the long term. However, tactical investors who outperform over some time period can seldom reproduce their success in subsequent time periods, indicating that luck (not skill) is the main driver behind their apparently attractive results. In reality, tactical portfolios are generally not risk-managed in a very meaningful sense, such that even assuming modest skill, in the long run tactical investors will likely end up with lower terminal wealth than strategic portfolios.

When credible information affects market forecasts, New Frontier shifts the strategic portfolio weights, accounting for all plausible scenarios in our estimation models under the new information. These shifts adjust the balance of assets, but only in extreme cases eliminate all exposure to the downweighted assets or factors. For example, while it might be known with some certainty that treasury yields will suffer as interest rates rise, people have been predicting disaster for a long time now, and although treasuries have generally underperformed equities as expected, they have continued to provide some portfolio risk reduction in a holistic sense. For example, the duration balance within the treasuries in our portfolios has shifted over a recent time period to a shorter overall duration in response to credible scenarios in which interest rates rise, but not as a panicky response to fear mongering.

It is a normal and desirable feature of strategic portfolios to have mixed performance in terms of single period asset returns. This variety of asset performances means that the portfolio risk management policy is working. The operating assumption for strategic investing is that markets have generally positive expected returns, and by seeking exposure to many different assets, the gains will more reliably outweigh the losses over the long run. As the riskier assets reach their peaks and begin to fall in value, the cycle reverses, and the formerly less attractive assets will protect the investor from more extreme losses in the following period.

20/20 hindsight always beats prediction. The future is uncertain, and nobody has a crystal ball. There is no such thing as "normal" markets to which turbulent markets return. While patterns and trends may emerge, they dissipate and change direction unpredictably. In spite of what pundits and "experts" would have us believe, the only accurate predictions based on legally obtained or actionable information include ranges of outcomes and/or multiple scenarios. Otherwise, the confidence in their predictions is misplaced, and is likely an attempt to lure investors with a false sense of security.

History has shown the benefits of New Frontier's strategic approach to investing – we do not rely on directional bets or luck, and our portfolios sustain their value through many different market environments. Investors tend to avoid unsuccessful investment strategies, and gravitate toward the successful ones. At first, with only several years' track record, some lucky strategies are mixed in with the truly effective ones in the "winners" category. Fate ultimately reverses for the strategies that were simply lucky, so only the truly effective strategies end up with long track records of outperformance. New relatively untested strategies with several years' track record of outperformance are always popping up to replace last year's failures. New Frontier's strategic investment process is not a fashionable response to a particular investment concern – it is a robust solution for all market seasons. New Frontier's process is not designed assuming that we have special predictive ability or luck, but rather to smartly straddle the plausible range of outcomes by synthesizing all available sources of information. This is why our strategic portfolios mix assets with recent outperformance with other less glamorous ones: to attain the most stable position for the realistic uncertainty about the future and maximize the prospects for long-term wealth.

This note was posted as an entry on New Frontier's investment blog on December 12, 2013. Read this entry and other posts at: newfrontieradvisors.com/blog.