BROKEN PIE CHART

5 Ways to Build Your Investment Portfolio to Withstand and Prosper in Risky Markets

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BY

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For Kelly and Jackson

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PREFACE: DID 2008 TEACH US ANYTHING?

Leading into the 2008 Great Recession most investors had some form of a traditional asset allocation. The usual mix of stocks and bonds that could graphically be shown in a nicely created pie chart on statements. Many were surprised to find out it did little to insulate them from a severe drawdown in their assets. You would think things would have changed? There would be mass adoption of using new methods to construct portfolios? Sadly, I see more of the same approach.

While investment pie charts may be broken for our current markets, I didn't see much in the way of discussion in the media on the subject. My motivation in writing this book was to highlight why traditional asset allocations may fail in the coming decades. Too often annualized historical returns are quoted from many years of past performance. Unfortunately, most individuals have windows of opportunity that might span only 10, 15, or 20 years. Will the prime investing years realize the average or something worse? What happens if markets have sharp corrections? What if markets are stagnant offering little cumulative returns?

In the coming chapters, we will examine why traditional portfolios may not be your best chance at success in the coming decades. We'll also investigate the potential for bonds to have a lost decade or two leading to little real returns. Instead, new asset classes will be discussed to modernize your investment pie chart. One of the goals in writing this book is to increase all your probabilities for maximizing your assets into retirement and have the ability in retirement to support the lifestyle you hoped for.

These days we see more and more concentration into broad exchange traded funds. We have Central Banks around the world with record levels of assets on the balance sheets. The Federal Reserve may or may not be successful at winding down their balance sheet. Interest rates have been the lowest in over 500 years in many parts of the world. This distortion in keeping rates low has caused future earnings to be discounted down barely with such low rates.

When we examine all the debt countries around the world are racking up, it is staggering to think what their interest payments on the debt will become if rates should rise. Even at the current low interest rates, debt continues to grow to levels that would make it hard to believe could ever be contained.

If you look at the economy, while unemployment statistics are approaching full employment by historical yard sticks, real wages have not really grown much since the 2008 recession. All of the additions to the money supply might eventually lead to inflation or maybe growth will stay in the "low growth" environment some point to.

With low rates, where investors don't earn much in traditional bonds, those approaching retirement using classical asset allocations might not earn a real return above inflation in the next decade. Or worst case, rates spike and all those bond funds see significant losses in their market values.

When we look at how success is measured we continue to hear about how a 60/40 portfolio has performed or how some blend of stocks and bonds over long periods of time have provided really nice average annual returns. Yet if an investor only has 10 years to retirement why chance not getting the average? Considering there have been long periods of relatively flat returns with corrections build in, wouldn't it make sense to seek out new approaches and alternatives? Too often retirement savers still need growth but can't afford to take on the downside risk of equities with no downside protection.

Speaking of downside, all too often investment performance ratios that are based on using the standard deviation or volatility of past years might miss out on what is truly important to someone who has specific goals. More and more though we continue to see investors and retirement savings boxed into some asset allocation based upon not what they need but simply how old they are. Sometimes those investments are misunderstood and unfortunately the true downside risk inherent in the underlying makeup of the investments.

As we move forward there needs to be consideration for the number of years an investor has until events like retirement. The idea of using a risk tolerance and age to build a portfolio with assumptions for forward returns based upon at times over 100 years of historical returns may be setting up people to fail. For many years, the mix of equities and bonds seemed to balance out risk. On the equity side, you shot for growth while bonds paid out a nice annual rate of interest. Those interest payments made forgoing growth on that portion of the pie chart palpable as the cost to carry fixed income was not that great.

As we will find rates falling from the highs of 1981 for the next 35 years cause outsized returns in many years for bond funds. If rates stay low, there is very little to be gained by just collecting interest payments that may only beat inflation by a tiny bit. If rates do rise they threaten to mimic the hit to market values of the 1970s albeit with less margin for error since unlike that period coupon rate payments will not be in the double digits.

Portfolios need to be built with the time frame of peak effect on assets. Someone with 5 years but needing growth to spur retirement income may not want to just use the same old age-based asset allocation. Many investors have a 10- to 15-year window to maximize returns. Relying on their window being within a great bull market isn't enough. What if markets suffer from a sideways market over years? What if there are significant pullbacks like in the early 2000s and 2008–2009?

The good news is there are new updated pie charts available if you know where to look. With the advances made utilizing options strategies can build in hedges and buffers to risk. Portfolios can contain strategies that look to sell outsized volatility premium in the markets. Unfortunately, many portfolio choices available in 401k's are just a mix and match of the standard classical asset classes.

Portfolios are still constructed using methods dating back to 1950s and 1960s yet we don't use the same phones. We don't drive the same cars. Respectfully I would ask, why are we using the same asset allocations? If we are setting up for a period of very low bond yields and lower growth, allocations should be modernized.