INSIGHTS

Investing in today's markets without a crystal ball

Russell Investments

It's no secret: Today's investing landscape is challenging. Amid a backdrop of historically expensive valuations for U.S. stocks, shifting geopolitical risks, changing monetary policy regimes and late-cycle risks, it's arguably harder than ever before to chart a path to financial success. While we can't offer up a crystal ball for assistance, we do believe there are some specific ways to potentially help investors navigate today's murky waters.

We recently tackled the issue head-on in our latest podcast, *Investing Without a Crystal Ball*. Below is a recap of the highlights and key messages from this recording.

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What concerns are paramount in the financial industry today? An insider's perspective.

From a financial industry perspective, we see three main concerns today. The first is the lack of savings among many working individuals, due in large part to low savings rates and a lack of market holdings for many, plus the Great Financial Crisis (GFC) and the ensuing less-than-ideal working environments that have followed. Second is the continuing widespread scepticism by the public of the financial industry as a whole. This lack of trust is also due in large part to the fallout from the GFC. As an industry, we didn't cover ourselves with glory 10 years ago, as fraud, scandal and poor forecasting ran amok.

The third concern is on the fees front. With the rapid rise in popularity of indexing—be it ETFs or index funds—there's been tremendous downward pressure on fees. This is a great thing for clients overall, but for the asset management industry, grappling with this shift has been a challenge. We believe it's imperative to find a better way to operate in this new-world environment, while simultaneously restoring public trust, in order to best help clients reach their desired outcomes (with savings for retirement a stated objective of many).

Enter a new approach: Client-centric thinking

The financial industry, rightly or wrongly, has always innovated in the past. But today, we're starting to see change percolating throughout. You can (for once!) credit the GFC. Why? The events of 10 years ago caused many within the industry to broaden their focus beyond excess returns—and to shift their concern to investor-desired outcomes instead. In other words, the focus shifted from simply beating a benchmark to actually listening to a client's objectives. *I want to be able to save enough money for retirement* or *I want to have an impact on the health of my community* became guiding lights, as advisers focused more on the client behind the portfolio, rather than seeing the portfolio as digits on a spreadsheet.

We've seen this at the adviser level, at the institutional level and among financial professionals across the board. Simply put, this evolution—this innovation—boils down to **doing right by the investor, as opposed to focusing on strictly making money**. *What's the client objective we're trying to achieve* is starting to become the rallying cry for more asset management shops and advisers alike. It's no question that this is a win-win for all.

But, how can we meet these objectives in today's market environment?

Of course, innovation can only take us so far. Just because we, as an industry, have finally awoken to the realisation that outcomes matter more than benchmarks, doesn't mean the outcomes are any easier to meet—especially with today's late-cycle dynamics in mind.

This is where, from our vantage point, active management can provide a timely assist. Why? Because 2018 has been a year plagued by volatility, with markets seemingly moving up and down on a dime depending on the latest trade war news, earnings report, or central bank announcement. With a dynamically managed portfolio, we believe money managers can take advantage of this volatility in real-time—by buying quality stocks at relatively cheaper prices, for example.

Secondly, during late-cycle phases like today's, there tends to be a more of a dispersion—or gap—between the performance of market sectors. Case in point, during the second quarter of 2018, the energy sector was up roughly 10%, whereas financials were down about 8%.[1] In our view, this type of dispersion can allow for an improved active management environment if the right managers are successfully picked.

The importance of knowing your competencies

Of course, no single manager can be an expert on each and every sector of the market. This is why, at Russell Investments, we see great value in recognising your own competencies AND knowing when to turn to third-party experts for help. When it comes to the specific stock selection within a portfolio, for instance, you're not typically going to know as much as a dedicated money manager who specialises in the area. So, we say: Hire the money manager you believe is best—the one with the deepest insights.

The key thing to bear in mind here is that the client's desired outcome should never be compromised for the sake of pride. At Russell Investments, our team of portfolio managers has an oft-repeated mantra to make sure we abide by this: First, do no harm. In other words, don't mess up a client's long-term plan simply because you're unwilling to work with others who are better than you in certain areas. Acknowledge your proficiencies and know when to partner.

Three lenses to analyse a portfolio by

We believe there are three main lenses to best examine a portfolio by in today's market environment:

- Historical performance
- Fundamentals
- Risk

Historical performance is simply looking at how the portfolio performed in past market events. I.e., how did it perform in an up or down market? What happened to the portfolio when interest rates rose? Fell? When emerging markets took a hit? What was the historical beta, volatility, max drawdown, etc.

Fundamentals means taking a look at valuations, earnings growth rates, duration, credit ratings, etc., to bring all the key measures into alignment with the scenarios you see going forward.

Risk means factoring in all potential hazards to the portfolio. We believe a good way to gauge this is by running stress tests on the current holdings of the portfolio. For instance, stress-test spreads by blowing them out by 100 basis points. What happens to the portfolio then? Or what if we re-ran the global financial crisis, what would the current portfolio's performance look like and is that an acceptable level of failure?

Collectively, we believe that assessing a portfolio across these three lenses allows you to get a down-in-the-weeds view of the portfolio's performance capabilities. It's not unlike a batting average. Are you getting a greater percentage of the things that you do right, rather than wrong? And, of the ones that you are getting right—are you getting them *really* right, so that their impact on the portfolio is magnified?

On the flip side, what about losses? Are they being limited? Are the failures acceptable, versus unacceptable?

Scrutinising a portfolio under these three lenses not only leads to a deeper understanding of how on track things are, but it can also spark new questions, and lead to further innovation.

Real-world scenario: February 2018

Let's walk through a real-world scenario to see how this can work. For instance, take the market downturn earlier this year, when bond yields went up as equities fell. Our research and risk models both showed that there weren't a lot of assets that have performed well in the past when both bonds and stocks were down. We noted that within this environment, commodities have historically performed well.

The screaming take-away here? **During times of market volatility, we believe the key to potential outperformance is to find the things that are different.** Active management, by its very definition, does just that.

Weighing geopolitical risks

In a year filled with unpredictability, trade war risks are probably at the top. It goes without saying that these are fluid, unpredictable and hard to model. But, at the same time, they're very real. So, how should a portfolio manager take this all into account?

We're of the belief that you can't have a tail risk dictate how you manage the central scenario of a portfolio. But, you *can* assess the different plausible outcomes—and envision a worst-case scenario. From there, we think it makes sense to determine whether that outcome is acceptable or not for the client. Speaking candidly, there will inevitably be times when an *unacceptable failure* does occur because a surprise comes about that's bigger than expected.

Importantly, though, we believe that a portfolio can't be managed to this. Why? Because we believe

[1] Source: MSCI Index, Russell Investments (USD)

in a volatility risk premium. If you pay for downside protection strategies in the marketplace, through the options in your portfolio, you may be paying so much away that over time, you end up losing. This is due to the simple fact that markets go up more than they go down. **So, if you managed every risk, you may also manage away every return.**

Truth be told, we believe that in this industry, we need to be both realistic AND optimistic. As we see it, there are times when we need to take risk—and times when we need to manage it. From our vantage point, some risks are so small, and have such a low probability of occurring, that it's unnecessary to build them into a portfolio. Others naturally warrant more attention. Ultimately, bear in mind that while no one can predict risk, the reaction to it when it occurs is what typically Another risk in today's market that we hear about frequently is the risk of being defensive in a portfolio too early—in other words, the fear of missing out on potential returns. FOMO. In many clients' minds, this risk is just as bad, or worse, than the risk of loss.

There's no easy solution to this conundrum, but we do believe it helps to really dig into the investor's mindset in this case. Ask yourself, what's more behaviourally acceptable for my client? Try to control emotions through process, rigour and repeatability—and know the behavioural mistakes you're most likely to make.

Furthermore, as an adviser, it's imperative to be straightforward in all your client communications at this stage. Be transparent. We see great value in talking with clients through current portfolio positioning, reasoning, rationale and time horizons. In our view, one of the financial industry's greatest challenges in managing risk today is not deviating from everyone else in the herd just because something makes sense in the short-term.

If the client's primary objective is long-term, don't stray from the established path. Truth be told, it's very hard for an investor to achieve only an 5% return when everyone else is getting 15%. Yet at the end of the day, this may very well put your client on a smoother path that's more survivable when it matters most: the long-term.

The bottom line

We believe that the financial industry has made great strides over the past decade, evolving since the Financial Crisis into a more client-focused industry. Yet today's uncertain market environment makes it harder than ever before for advisers to meet client objectives. In light of this, we believe that deploying active management strategies that can potentially unearth additional returns, while simultaneously conducting careful portfolio risk analysis, may be well worth considering.

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Important Information: