

## Will Bonds Protect in the Next Bear Market?

By: Henry Pizzutello, Chief Investment Officer

With equity markets re-testing all-time highs (again) portfolio protection is now at the top of many investors' minds. Indeed, there is no shortage of reasons for these thoughts—yield curve inversions, impact of trade wars, threats of impeachment, to name just a few—and many investors are justifiably concerned about how their portfolios will hold up during the next “down cycle.”

The traditional recommendation for portfolio protection was typically a larger allocation to bonds to hedge equity exposure. During the financial crisis this strategy helped to limit overall losses as equities dropped 50% peak to trough while the Barclay's Bond Index rose 6%. The effect on the average portfolio was not insignificant – a “traditional 60% equity / 40% bond portfolio lost approximately 27% during the same time that the S&P 500 Index fell 50%.

However, the recession playbook may have to be re-written. Given the ultra-low global rate environment and the current level of U.S. Fed Funds, there is a significant challenge for the traditional bond allocation to offset a significant decline in equities.

During the last three recessions, the Fed entered an extended period of loose monetary policy in order to help the economy. In all three cases bonds performed well, rising an average of 30% while the Fed was in easing mode. However, each recession started with the Federal Fund rate over 5%. In each case the Fed was able to cut over 500 basis points from short-term lending rates in order to help boost the economy during a recession. Today, the landscape is much different, with short-term rates in the 1.50%–1.75% range. Were a recession to start today, the Federal Reserve would have much less “dry powder” to

implement a loose monetary policy. Additionally, given the lower absolute level of bond yields, there would be less of a value increase, and conversely, weaker protection. With less of a value increase, the protection role of bonds is much weaker than before.

Of course, there may not be a recession on the horizon. As John Kenneth Galbraith remarked, “The only function of economic forecasting is to make astrology look respectable”. Economists have been known to be wrong in the past, so basing a portfolio allocation on the predictive abilities of the economists' forecast is not conducive to long-term success. However, understanding the cause and effect of potential outcomes on a portfolio is a key factor over the long-term. Given the potential issues that traditional fixed-income allocations are facing today, the astute investor needs to be looking at more “non-traditional” sources of fixed income to help with the overall portfolio protection problem. Focusing on absolute levels of risk and capital preservation in the fixed income sector will help to identify other less traditional asset classes and structures that can provide both a reasonable return and the desired negative correlation to equities when needed.



# Do you have to “Bet Big to Win Big?” By: Henry Pizzutello, Chief Investment Officer

Most people “know” that in order to make more money on your investments, you need to take on more risk. It is taken as fact that the higher risk portfolio will outperform a lower risk portfolio over time, and that higher returns are a function of accepting more risk into a portfolio. However, this is not entirely true. Higher risk does not necessarily mean higher return; it means the possibility of a higher return. However, as the risk coin has two sides, what many investors often fail to realize is that higher risk also carries with it a higher possibility of significant loss. The timing of these losses can have a significant effect on your long-term investment goals. If you are a young investor who is still working and generating income, it is very likely that you will be able to “weather the storm” and wait for your investments to recover. A long-term focus is one of the tenets of a successful investment strategy. However, if you are closer to retirement age,

or about to retire, there are other factors to consider in creating your long-term investment plan.

The charts below provide a compelling picture to this point. The graphs show performance of a high-risk portfolio and a moderate-risk portfolio under two scenarios over 25 years. The left graph shows a market cycle of an early bull market, followed by a bear market in the later years and the right graph shows an early bear market followed by a bull market. In the first example, there is little difference in the returns of the two portfolios at the end of the 25 year period, as the larger losses in the later years are supported by previous year’s market gains. However, in the unlucky scenario in the right graph where there is an early bear market followed by the bull market, the high risk portfolio suffers losses that deplete the portfolio, to a level that cannot support client withdrawal needs.



“ In investing, what is comfortable is rarely profitable. ”

Robert Arnott

This illustrates what is known as portfolio “sequence risk”. It is quite simply the risk that the timing of withdrawals (or losses) from a retirement account will have a negative impact on the overall rate of return available to the investor. A higher risk portfolio increases the sequence risk during a bear market.

Many advisors rely solely on Monte Carlo simulations to calculate the probability of meeting an investment goal without incorporating any advanced planning discussions.

While having a high probability of success over the long-term is a desirable goal, it may also create a false sense of security because it likely underestimates the practical impact of that one bad path on the longevity of their portfolio. A computer can simulate 10,000 possible outcomes, but we are not simultaneously living 10,000 lives. If on that one path, you are unlucky and your portfolio declines 50%, you cannot just average away your losses over time, as the graph on the right shows. This can mislead investors into taking more risk than they should, especially early in the retirement investment cycle.

There are two ways to combat the potential downside of sequence risk. The primary tool is through a risk management process that prioritizes capital preservation from a risk-based portfolio allocation discipline. There are a number of things to consider in constructing a portfolio and each investment within the portfolio will have certain risk characteristics. By carefully monitoring each individual risk and their contributions toward the overall portfolio risk, you are able to take corrective action when risk rises above the portfolio's desired level. This process helps to reduce the probability of having a large loss event. Avoiding significant losses is one of the most critical factors to achieve long-term investment success.

The second manner to combat sequence risk is through portfolio diversification. Many investors' view of equity market exposure relates only to the S&P 500 or the Dow Jones Industrial Average, but in reality they represent only a slice of overall U.S. equity markets. In turn, the United States makes up only 54% of global equity exposure. Under normal conditions, global equity markets do not usually

rise and fall in lockstep and the diversification of returns provides a tangible benefit to portfolio performance.

However, the exceptional performance of the S&P since the financial crisis has created an environment in which diversification has been a drag on performance, and many investors have moved into index funds as the U.S. markets have led the world. However, just because diversification has not worked recently does not mean that it should be avoided, as the chart below illustrates. This shows the investment performance of a number of different assets over the past 20 years. It would be exceedingly difficult to continually pick the top performing asset each year, and even harder to determine which single asset would provide the best return over a 20 year period.

While the U.S. markets have been the best place to invest in the ten years since the lows of the financial crisis, the ten year period prior to the crisis was considered the "lost decade" as absolute returns for the index were essentially flat. During that period, emerging markets would have been the best place to be invested – the same asset class that many investors are moving out of today because of poor returns over the past few years.

The most efficient way to be invested over the long term combines elements of both diversification and management of overall risk within each asset class. Given the unpredictable nature of the investment markets, and changing life circumstances, a consistent focus on risk in order to avoid the "worst path" scenario will allow investors to win over the long run without having to "bet big".

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
S&P 500 Growth	MSCI Emerging Markets	Russell 2000 Value	Russell 2000 Value	Bloomberg Barclays High Yield	MSCI Emerging Markets	MSCI Emerging Markets	MSCI Emerging Markets	MSCI Emerging Markets	MSCI Emerging Markets	Bloomberg Barclays High Yield	MSCI Emerging Markets	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	MSCI Emerging Markets	Russell 2000 Value	S&P 500 Growth	S&P 500 Growth	Russell 2000 Value	MSCI Emerging Markets
42.16%	66.64%	22.93%	14.60%	19.38%	35.82%	25.85%	34.98%	32.17%	38.38%	5.24%	19.51%	39.89%	7.84%	18.33%	43.39%	14.89%	5.52%	31.74%	37.89%
S&P 500	Russell 2000	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Russell 2000	MSCI World ex USA	MSCI World ex USA	MSCI World ex USA	MSCI World ex USA	Russell 2000	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Russell 2000	S&P 500	S&P 500	S&P 500	S&P 500	S&P 500
28.58%	43.99%	11.83%	8.43%	-1.37%	18.44%	22.25%	14.47%	25.71%	12.44%	-26.14%	38.21%	26.85%	4.59%	18.55%	38.82%	13.69%	1.38%	21.31%	27.44%
MSCI World ex USA	S&P 500	S&P 500	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Russell 2000	MSCI World ex USA	S&P 500	S&P 500	S&P 500	Russell 2000	MSCI Emerging Markets	Russell 2000	Russell 2000	Russell 2000	S&P 500	S&P 500	Bloomberg Barclays High Yield	MSCI World ex USA	MSCI World ex USA
18.77%	29.24%	5.88%	5.84%	-6.16%	47.23%	38.38%	5.82%	33.48%	9.13%	38.83%	34.47%	24.95%	4.69%	17.68%	24.92%	12.34%	8.55%	17.40%	24.21%
S&P 500	MSCI World ex USA	Russell 2000	Russell 2000	Russell 2000	Russell 2000	Russell 2000	S&P 500	Russell 2000	Russell 2000	Russell 2000	MSCI World ex USA	MSCI World ex USA	MSCI World ex USA	MSCI World ex USA	S&P 500	S&P 500	Bloomberg Barclays High Yield	MSCI World ex USA	MSCI World ex USA
14.68%	27.82%	-3.02%	2.49%	-11.43%	46.93%	18.33%	4.91%	20.81%	7.55%	-33.78%	33.67%	18.89%	2.11%	16.81%	32.75%	5.97%	-1.58%	17.13%	23.17%
Bloomberg Barclays High Yield	Russell 2000	Bloomberg Barclays High Yield	MSCI Emerging Markets	MSCI World ex USA	MSCI World ex USA	S&P 500	Russell 2000	Russell 2000	Russell 2000	S&P 500	S&P 500	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Russell 2000	S&P 500	S&P 500	MSCI World ex USA	MSCI World ex USA	S&P 500
8.67%	21.26%	-5.86%	-3.81%	-15.88%	39.42%	15.71%	6.71%	6.97%	-34.92%	31.57%	15.12%	-0.48%	16.35%	32.39%	5.69%	-3.64%	11.96%	21.83%	21.83%
Bloomberg Barclays High Yield	S&P 500	S&P 500	Russell 2000	Russell 2000	S&P 500	Russell 2000	S&P 500	S&P 500	S&P 500	S&P 500	Russell 2000	S&P 500	S&P 500	Russell 2000	S&P 500	S&P 500	S&P 500	Russell 2000	S&P 500
1.87%	21.04%	-9.11%	9.23%	-28.48%	31.79%	14.81%	4.85%	15.79%	5.49%	-37.88%	27.17%	15.19%	-8.81%	16.80%	31.99%	4.89%	-3.13%	11.32%	15.38%
Russell 2000	MSCI World ex USA	MSCI World ex USA	S&P 500	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Russell 2000	Russell 2000	Russell 2000	Russell 2000	S&P 500	S&P 500	S&P 500	Russell 2000	MSCI World ex USA	Russell 2000	MSCI World ex USA	Russell 2000	Russell 2000
-6.49%	-2.83%	-12.73%	-11.37%	-11.71%	-20.89%	29.97%	11.13%	13.35%	1.99%	-38.54%	26.47%	15.06%	-4.18%	15.91%	21.82%	4.22%	-4.41%	11.18%	14.65%
Russell 2000	Bloomberg Barclays High Yield	S&P 500	S&P 500	S&P 500	S&P 500	S&P 500	S&P 500	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	S&P 500	S&P 500	S&P 500	S&P 500	Russell 2000	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	S&P 500	Russell 2000
-2.55%	2.39%	-22.68%	-11.89%	-22.19%	28.68%	19.88%	4.85%	11.85%	1.87%	-39.22%	21.17%	15.89%	-5.99%	14.61%	7.44%	3.45%	-4.47%	6.89%	7.54%
Russell 2000	Bloomberg Barclays High Yield	S&P 500	S&P 500	S&P 500	S&P 500	S&P 500	S&P 500	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	MSCI World ex USA	MSCI World ex USA	MSCI World ex USA	MSCI World ex USA	Russell 2000	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	MSCI World ex USA	MSCI World ex USA
-4.49%	-2.83%	-12.73%	-11.37%	-11.71%	-20.89%	29.97%	11.13%	13.35%	1.99%	-38.54%	26.47%	15.06%	-4.18%	15.91%	21.82%	4.22%	-4.41%	11.18%	14.65%
MSCI World ex USA	Russell 2000	MSCI World ex USA	MSCI World ex USA	MSCI World ex USA	Russell 2000	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	MSCI World ex USA	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield	MSCI World ex USA	MSCI World ex USA	MSCI World ex USA	MSCI World ex USA	Bloomberg Barclays High Yield	Bloomberg Barclays High Yield
28.34%	-1.49%	39.71%	21.49%	21.49%	39.71%	4.19%	4.19%	2.43%	4.23%	5.93%	5.93%	18.43%	4.21%	4.21%	4.21%	14.93%	2.63%	3.54%	3.54%



# PRESIDENTIAL ELECTION 2020

## Election Years & Equity Markets

By: Robert Borden, CFP, EA

As we enter the fourth quarter of 2019, attention is starting to shift to the 2020 election. We decided to take a look at history – specifically the S&P 500 performance both during the election of a sitting President and in Presidential election years in general. Going back to Eisenhower, we have had eight second-term election years excluding Ford (due to Watergate and its impact on the 1976 election). Those years were 1956, 1972, 1980, 1984, 1992, 1996, 2004 and 2012. A couple of noteworthy observations – the sitting president won six out of eight elections and the S&P 500 had an average return of 15.2% in those election years, with positive returns posted in eight out of eight election years. The years in which incumbent presidents lost were 1980 and 1992 and both had somewhat similar economic backdrops. The 1980 presidential election took place at the tail end of a recession (which began in 1979), while the 1992 election followed the 1990-1991 recession. However, in every other instance, positive economic growth both the year before and the year of the election was a clear signal that the election would favor the incumbent. Furthermore, going back to 1952, the S&P 500 has been up in every presidential election year with the exception of 2000 and 2008 – that's 15 out of 17 elections with an average return of 10.3%.

The key takeaway is that it would be very unusual for the electorate to vote President Trump out of office if the economy is still growing in 12 months, notwithstanding his itchy Twitter finger. Additionally, as the chart to the right illustrates, markets tend to perform well in Presidential election years, even with the potential uncertainty surrounding the outcome. Needless to say, President Trump is a polarizing figure, but not dissimilar to the last three sitting presidents that won reelection – Obama, Bush and Clinton.

Obviously, his acerbic style is particularly off-putting to the opposition party and to even some members of his own party. Still the very nature of our “winner take all” political system creates polarization and has done so since the election process was created. Are we more polarized today than we were 50 years ago? It certainly feels that way, but it's an open question. There is no question that the Democratic Party has become more liberal and the Republican Party more conservative with both having fewer elected political figures in the middle (think Blue Dog Democrats and Rockefeller Republicans). Of course the Democrats are raising the specter of impeachment and there is absolutely no certainty that history will repeat itself in 2020, but it should be an intriguing election season.

“My philosophy of life is that if we make up our mind what we are going to make of our lives, then work hard toward that goal, we never lose - somehow we win out.”

Ronald Reagan

Year	S&P 500 Return	Growth Rate (GDP) <sup>1</sup>	Candidates	Winner
1952	18.4%	4.1%	Eisenhower vs. Stevenson	Eisenhower
1956	6.6%	2.1%	Eisenhower vs. Stevenson	Eisenhower
1960	0.5%	2.6%	Kennedy vs. Nixon	Kennedy
1964	16.5%	5.8%	Johnson vs. Goldwater	Johnson
1968	11.1%	4.9%	Nixon vs. Humphrey	Nixon
1972	19.0%	5.3%	Nixon vs. McGovern	Nixon
1976	23.8%	5.4%	Carter vs. Ford	Carter
1980	32.4%	-0.3%	Reagan vs. Carter	Reagan
1984	6.3%	7.2%	Reagan vs. Mondale	Reagan
1988	16.8%	4.2%	Bush vs. Dukakis	Bush
1992	7.6%	3.5%	Clinton vs. Bush	Clinton
1996	23.0%	3.8%	Clinton vs. Dole	Clinton
2000	-9.1%	4.1%	Bush vs. Gore	Bush
2004	10.9%	3.8%	Bush vs. Kerry	Bush
2008	-37.0%	-0.1%	Obama vs. McCain	Obama
2012	16.0%	2.2%	Obama vs. Romney	Obama
2016	11.9%	1.6%	Trump vs. Clinton	Trump

<sup>1</sup> Source: <https://www.thebalance.com/us-gdp-by-year-3305543>