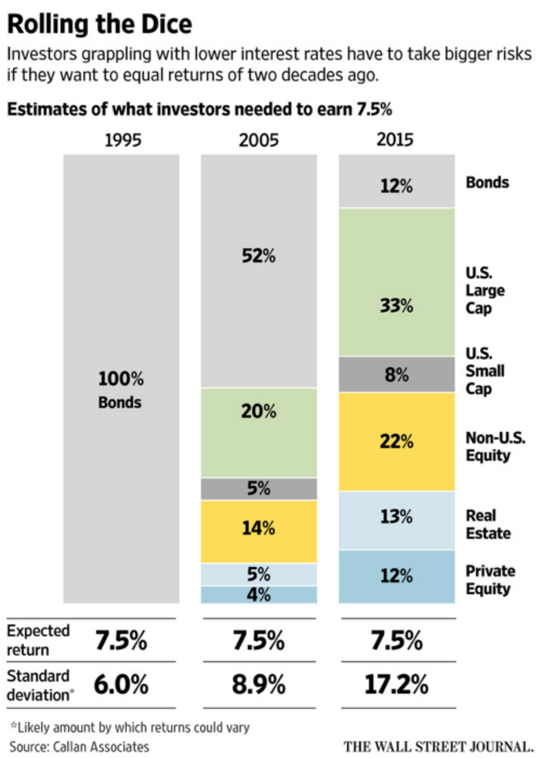
Rolling The Dice

SYNOPSIS

- One of the easiest ways to lose money is to refuse to accept the notion that markets evolve over time.
- Achieving the same return in conservative portfolios that existed years ago now requires a material increase in volatility and risk.
- Investors who expect a fixed level of returns must be willing to endure a variable amount of risk.

ONE CHART, THREE CONCLUSIONS

The Wall Street Journal published an excellent article on June 1, 2016, that summarizes the evolution of investment returns for pension funds over the last twenty years. The chart below shows just how dramatic the change has been since 1995.



There's a lot going on here so let's break down the data. The basic premise of the article was to show where a pension fund needed to invest to generate what was once considered to be a reasonably strong return of 7.5 percent.

> *Those who feel that they simply must continue to earn what was so readily available years ago are likely in for a wild ride…*

In 1995, a portfolio made up of all bonds would return the desired 7.5% with the expectation that returns could vary by around 6.0% (per the "standard deviation"), according to research by Callan Associates Inc.

To make the same return in 2015, investors needed to invest in new asset classes since interest rates have pushed bond returns so low. Adding these riskier investments subsequently increased the standard deviation up to 17.2 percent.

Said another way, if an investor kept its target return fixed over twenty years, that investor would be forced to endure almost three times the amount of volatility in 2015 versus 1995!

The major shift in what is needed to derive the same return brings us to three very important conclusions:

1. **Can't Hide from Volatility:** Since ultra-safe bonds no longer offer attractive returns, riskier asset classes must be used to achieve the same return.

Hence, expect portfolios that seek anywhere near this level of return to remain volatile for the foreseeable future.

2. **It's Harder**: The bad news is that diversification across multiple asset classes requires a lot of planning, analysis, and rebalancing over time. The good news is that it's still possible to achieve these returns as long as investors can stomach the rise in volatility.
3. **Welcome Higher Interest Rates**: Although rates are going to rise very slowly, the sooner yields on ultra-safe bonds rise, the better for those who need income.

Simply put, markets evolve over time, and one of the most effective ways to lose money is to refuse to accept this tenet of investing.

IMPLICATIONS FOR INVESTORS

As markets change so should investor expectations. This period of low returns may frustrate some, but it's important to assess the consequences of expecting a fixed level of return.

Those who feel that they simply must continue to earn what was so readily available years ago are likely in for a wild ride and should think about their ability to tolerate the added volatility. In reality, many investors say they can stomach volatility until it arrives. Then, when faced with a major swing in value, the pain really begins to hurt.

The paper losses mount higher until panic takes over and forces the investor to sell, which does nothing more than convert temporary pain into permanent damage. This must be avoided at all costs, and the best way to protect against panic selling is by being honest with oneself. Everyone has a different tolerance for volatility, and leaving a comfort zone can often do more harm than good.

This market is a frustrating one, and something that we haven't encountered since the 1930s. But just as the easy returns experienced twenty years ago did not last forever, we won't be stuck in this low return environment for eternity either.

The million-dollar question is how long this will last, and that's tough to answer. I expect to see returns rise over time, but they will most likely not return to the days of five percent in a bank certificate of deposit for a generation or two.

The bottom line is that if investors want to continue to achieve the same returns that were easy to find years ago, they must be prepared to (1) endure more volatility, and (2) expose them to an even greater risk of panic selling somewhere down the road.

NOTE*: Read the Wall Street Journal article here (subscription required): http://www.wsj.com/articles/pension-funds-pile-on-the-risk-just-to-get-a-reasonable-return-1464713013*

Sincerely,

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