HOW TO GET COMFORTABLE WITH BEING UNCOMFORTABLE

This report discusses the tremendous headwinds traditional investors will likely face in the next 10 years and the steps required to turn a bad situation into a great opportunity to thrive not just in the next cycle but for the rest of their investment lives.
With investing, you can either be comfortable or successful - but not both. What do we mean by this?

Looking back over the past decade, investors can be forgiven for thinking investing is an easy game. After all, you just had to buy the S&P 500 near the bottom of a bear market and ride the rebound to earn double-digit returns. But this hindsight bias engenders a dangerous illusion.

In fact, most investors were too terrified to buy stocks in 2008 and 2009 as it seemed like the financial world was collapsing. And there have been many other terrifying hurdles over the past ten years that kept many investors on the sidelines.

Moreover, the strong performance of the S&P 500 obscures an important reality: U.S. stocks have been the only game in town. While U.S.-oriented investors were living large on the performance of FAANG s, international stocks and most currencies left non-US investors with low single-digit returns.

The fact is, investing is hard. Even worse, the next decade is likely to be harder than most. This will require advisors to diversify into alternative strategies so that client portfolios don’t fall behind on their goals.

Those who heed the lessons of past market cycles and the well-established principle of true diversification may have an unprecedented opportunity. Those who choose comfort and traditional portfolio construction methods may not be so lucky.

So what do these uncomfortable realities look like?
TIME TO GET COMFORTABLE WITH LOWER FUTURE RETURNS

The vast majority of investors rely solely on domestic equities and bonds to achieve their financial objectives.

Now there are times when just these two assets could provide sufficient returns at a suitable level of risk to achieve an investor’s goal – but is now one of those times?

We know that a bond’s current yield is the best estimate of its total return. Currently, the iShares Core U.S. Aggregate Bond ETF (AGG) is yielding 3.3% and global bond indices are at even lower yields.

On the equity side of things, stocks should be expected to produce below average returns when they are priced above their average long-term valuations. Currently, and even after accounting for an upward drift in valuation multiples over time, U.S. stocks remain well above their average, long-term valuations.

Figure 1. S&P 500 Cyclically Adjusted Earnings Ratio, 1881 – 2016

Source: ReResolve Asset Management. Data from Robert Shiller.

Together, these two factors signal a major headwind for traditional portfolios over the next ten to fifteen years.

In fact, after adjusting for inflation and fees, we estimate that investors will be hard-pressed to earn more than 2.5% per year on traditional portfolios of domestically focused stocks and bonds over the next decade. Note that our forecast is in the middle of the range of capital market forecasts documented by other firms.

While we’d love to believe that these sobering statistics are sufficient to motivate advisors to reduce their exposure to US centric portfolio allocations, the reality is that most will prioritize comfort over success.

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3 To learn why valuations might be expected to rise over time, please read “Get Comfortable with Being Uncomfortable, Part 1: Valuations” on our blog at the following link https://investresolve.com/blog/get-comfortable-with-being-uncomfortable-part-1-valuations.

4 To see calculations for this estimate, please read “Get Comfortable with Being Uncomfortable, Part 1: Valuations” on our blog at the following link https://investresolve.com/blog/get-comfortable-with-being-uncomfortable-part-1-valuations/. Note that we have updated estimates to reflect current yields and valuations as of August 31, 2018.

5 For a survey of return forecasts from several respected firms including Vanguard, Morningstar, and Research Affiliates see this report https://www.morningstar.com/articles/842900/experts-forecast-longterm-stock-and-bond-returns-2.html
A status quo attitude is understandable, given that clients are heavily influenced by recency bias, tracking error bias, home country bias and a host of other hidden factors. But make no mistake - this continued overexposure to the globe’s most expensive market means that advisors will need to prepare clients to get comfortable with lower expected returns than those experienced over the past three decades.

**TIME TO GET COMFORTABLE WITH BEING DIFFERENT THAN YOUR PEERS**

If you’ve taken to heart what we’ve written above, it’s natural to wonder, “How can I help clients to reach their financial objectives in such a low return environment?”

A solid first step might be for investors to consider emphasizing global asset classes and less common markets like inflation protected bonds, and potentially commodities.

Diversification across these global asset classes is important because they are expected to respond in a very predictable manner to changes in growth and inflation. As you can see from the chart below U.S. stocks and bonds only thrive in **ONE** of the four potential economic regimes.

U.S. stocks and bonds respond most favorably to the ‘Disinflationary Boom’ period located in the bottom right corner. This is in stark contrast to the asset classes that do well in the exact opposite “Inflationary Stagnation” regime where TIPS, gold and commodities thrive while US equities and bonds tend to do very poorly.

Figure 2. Asset class responses to the four major economic environments.

Source: ReResolve Asset Management.
TIME TO GET COMFORTABLE WITH INVESTING IN ALTERNATIVE INVESTMENTS

We’ve made a strong case that it is paramount to consider a global universe of asset classes.

But how might advisors make best use of these new markets to further maximize clients’ chances of success?

It should be no secret that many market participants make sub-optimal investment decisions based on behavioural flaws that result in profits being left on the table.

If investors misbehave in relatively predictable ways – by herding, over/underreacting to new information, anchoring, etc. - then there is an opportunity for other investors to earn excess profits by investing in a manner that arbitrages this behaviour.

Most alternative investment strategies tend to harvest one or more of these forms of misbehaviour. We’ve highlighted a few such approaches in Figure 3. As you can see, the excess profits earned from these alternative approaches can be quite lucrative. Better yet, they are uncorrelated with one another, and can serve as extraordinary diversifiers for traditional asset classes.

Figure 3. Annual excess returns to long-short global factor portfolios scaled to 10% annualized volatility, 1990 – 2012


Stated plainly, the combination of strong potential returns to alternative strategies and superb portfolio diversification presents an opportunity to substantially increase the returns that investors receive for the amount of risk they take.
IN SUMMARY

With low yields on fixed income and elevated valuations for North American equities, investors are unlikely to achieve their required returns from traditional portfolios over the coming decade. Investors who adhere to conventional portfolios should acclimate to the fact that their retirement may be less comfortable than they were expecting.

The steps outlined above – setting realistic expectations, diversifying as much as possible, and taking advantage of unique alternative strategies – can help investors navigate a future that may be radically different from the recent past.

The point is this: If investors want successful financial outcomes in coming decades, they need to get comfortable with being uncomfortable.
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