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Protection or Perfection?

Separate from the drawdown that occurs from future income withdrawals, retirement investing should also seek to protect a portfolio against the possibility of an extended period of price decline. Assuming a withdrawal plan is based on the concept of maximum sustainable income over the long-term, a serious erosion of assets can threaten income longevity as well as emotional well-being. The tension between earning an acceptable investment return that can lengthen sustainable income and the desire for protection against an extended market decline is perhaps the most vexing challenge for retirement investing.

Asset allocation has long been the first principle investors rely on to help offset volatility. While diversification among low correlated asset classes can be a sound strategy, the current environment of low bond yields and a near-zero return on cash have diminished the protection they have historically provided. In addition, the income returns of cash and bonds now stand markedly below the 4% annual withdrawal rate most retirees rely on.

Designating a larger percentage to stocks than a customary 50/50 stock/bond allocation can increase the potential for higher future returns, but overweighting stocks to bonds can also increase the possibility for price decline. Left with this investment conundrum, we believe the best approach is to consider active portfolio adjustments to stocks versus bonds.

A tactical asset allocation strategy enables a portfolio to shift from a 50/50 stock/bond mix to a 75/25 allocation of stocks to bonds when conditions are favorable for equity markets, which historically is the majority of the time. But equally important is the ability of the tactical asset allocation strategy to downshift its overweight in stocks while adding more bonds or cash to the portfolio when equity market conditions begin to deteriorate.

Long and extended market downturns typically occur with the onset of a lengthy decline in the economy. Based on a view that stock prices follow the expectations of future earnings, and that a downward trend line can be evidence of a weakening economy, this measure represents a "risk-off" indicator signaling the prudent reduction in a portfolio's stock allocation.

However, what has become clear is that the stock market is now more volatile in the short-term reflecting not only the dynamics of a cyclical global economy but the noticeable change in market structure. The increased use of passive index investing has led to wide swings in stocks as investors bounce in and out of the market. High-frequency trading (HFT), a pronounced strategy used by many hedge funds, has also led to increased market volatility. Lastly, the use of derivatives—options to hedge positions—have reached a point where option volume now exceeds stock volume. As a consequence, the stock market is now a derivative of the option market.

As we know, the stock market can be volatile in the short-term reflecting both a dynamic economy as well as the ebb and flow of market imbalances described above. As such, there is now an increased propensity for "market shocks" across global financial markets. These market shocks, akin to weather tornados, can be extremely violent and highly destructive. One analogy for sensitizing tactical allocation during these periods is comparable to how a golf course manages dangerous weather. Most have installed a warning system that sounds a horn signaling course closure if lightning strikes within a certain radius (normally 10 miles). The warning horn starts a countdown period that if no further strike is detected course play can resume.

We believe incorporating both a market shock warning signal as well as a longer-term cyclical risk-off indicator can be useful as a basis for

tactical decision making. When both conditions are favorable, the tactical asset allocation strategy will be 75% invested in stocks to seek higher returns. But when one or the other condition is flashing a warning signal, the strategy can defensively sell stocks and allocate to cash or bonds.

Investors often assess tactical allocation based on how it performs versus a fully invested index such as the S&P 500. Is it in the correct position—defensive when the market is going down or in an offensive position when stocks are rising? This being said, it is important to understand tactical asset allocation is a probabilistic exercise which seeks, above all else, protection when the odds favor being defensive.

Perfection in asset allocation, being right 100% of the time, is unachievable. Knowing this, it is important to understand the goal of an asset allocation strategy is portfolio stability and positive returns while acknowledging positive investment returns supersede trying to outperform the market.

Retirement investing involves consequential choices of risk and return. Investors in the decumulation phase of their retirement years must learn how to tactically balance both stocks and bonds in order to reach their long-term financial goals. Yes, growth and capital appreciation are essential to fund future withdrawals but downside volatility also matters in portfolio management—both in magnitude and length—in the context of income withdrawals. We believe that tactical asset allocation can help provide the flexibility to address this challenge.

Richard E. Cripps, CFA, Senior Investment Strategist, founded EquityCompass in 2008. His prior responsibilities include Managing Director of the Portfolio Strategy Group at Stifel Research and Chief Market Strategist and Co-chairman of the investment committee at Legg Mason Wood Walker, Inc. He began his career in 1979 as a Financial Advisor with Legg Mason. The EquityCompass investment philosophy and process were developed by Richard from his broad industry experience authoring numerous investment-related research studies, creating and monitoring portfolio models, and participating in Economic forums that include the White House on policy implications of corporate dividend taxation. Richard has a B.B.A. in Finance from James Madison University where he was also a member of Executive Business Council. He is also a CFA charter holder and member of the Baltimore Security Analyst Society.

Robert G. Hagstrom, CFA, joined EquityCompass as a Senior Portfolio Manager in April 2014 and launched the Global Leaders Portfolio in July 2014. In 2019, Robert was named Chief Investment Officer of EquityCompass. Prior to joining EquityCompass, he was the Chief Investment Strategist of Legg Mason Investment Counsel, and before that, the Portfolio Manager of the Growth Equity Strategy at Legg Mason Capital Management for 14 years. He has also served as President and Chief Investment Officer of Legg Mason Focus Capital and General Partner of Focus Capital Advisory.

Robert is the author of nine investment books, including *The New York Times Best Seller, The Warren Buffett Way, The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy, and Investing: The Last Liberal Art.* He earned his Bachelor and Masters of Arts degrees from Villanova University and is a member of the CFA Institute and the CFA Society of Philadelphia.

About EquityCompass

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The EquityCompass team of professionals represents deep industry experience in security analysis, capital markets, and portfolio management. We are committed to a consistent investment process that relies on enduring principles, sound empirical reasoning, and the recognition of a dynamic investment environment with a global reach.

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