Van Hulzen Asset Management

LOOKING AHEAD: RISING VOLATILITY FOR MOST PORTFOLIOS

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Volatility refers to the amount of risk and uncertainty in an investment security. Specifically, the size of price changes in the future. Typically, more uncertainty requires a higher return. It is the offsetting of risk with potential reward. An investor who owns a security with a low degree of uncertainty – say for example the very low chance of not receiving investment principal back from the US Treasury – demands a much lower yield than an investor who lends money to a start-up business trying to open its first store. The risk of a first year business failure will require the investor to demand a high yield.

Past volatility of investments is observable and can be used to estimate future volatility. By putting various investments together into a single portfolio, the entire portfolio's volatility can be estimated. If the portfolio has been well constructed, the volatility of owning a combination of investments should be less than owning only a single security. Let's say that a shop owner in Colorado sells ice cream. Sales in the summer months are strong but by winter, ice cream sales are only a fraction of the peak season. The shop owner could reduce the volatility of sales by adding hot chocolate to the menu. The change in weather brings a change in product sales. The combination of ice cream and hot chocolate reduces the shop owner's risk of losing money.

For almost all investors, equities are paired with fixed income assets to create a less volatile portfolio of investments. This process of diversifying investment allocations is widely used by financial professionals.

Asset allocation is the process of using past volatility to estimate future risk. When a portfolio is constructed, the builder seeks to match the expected volatility with the investor's tolerance for losses.

However, volatility is not constant. It ebbs and flows like the tides. A shop owner may sell ice cream and hot chocolate and in the process, reduce the volatility of monthly sales, but the shop owner's town may experience a natural disaster or lose a key employer causing either a temporary disruption in demand or a more permanent loss of consumers. Temporary disruptions and more permanent shifts in consumption trends occur constantly throughout an economy. These factors are external to the shop owner's business model and cause severe and sudden periods of volatility. They are largely unknown and mostly beyond the shop owner's control. Larger trend changes may not be entirely controllable, but can often be observed in the early stages of change. An alert shop owner can make the adjustments necessary to reduce the risk of an external factor. If the population around the shop owner's location is in a long-term decline, a new location may be required.

CYCLICAL VOLATILITY AND ASSET CORRELATION

For nearly thirty years, US interest rates have been stair-stepping down from the mid-teens to the all-time low hit last summer. A 30-year trend is very long in terms of investment cycles. The stock economy tends to have a period of economic expansion and economic contraction (one cycle) roughly every 7-8 years. The interest rate trend has remained fairly constant throughout several economic cycles.

In terms of stocks and bonds, stocks typically contribute most of the volatility in a portfolio while bonds pay income and help reduce risk. For many of these past thirty years, the coupon (interest rate paid on the bond purchase) has been falling, but as rates fell, bond prices rose. Between 1982 and 2012, US investment-grade bonds returned 8.38% to investors annually (Barclay's US Aggregate Bond Index according to Bloomberg data). That total return was made up of both interest payments and price appreciation and served investors well.

Today, the index fund that tracks the Barclay's US Aggregate Bond Index is paying an interest rate of 2.8%. With interest rates still in shouting distance of their all-time lows, investors would be hard pressed to expect 8% returns out of bonds going forward. The Federal Reserve is still seeking to maintain a low interest rate on short-term bonds, but as the Fed tapers its bond buying, longer-term interest rates are more likely to move up or remain in a state of equilibrium (trade within a range). In either scenario, an 8% return would be impossible.

Investors who are willing to take on more risky bonds can still earn 6% interest according to the junk bond index tracking fund. However, before moving into high-yield bonds or making any other changes to allocations in bond investments, it is an important note that with the 30-year trend complete, the entire fixed income universe is likely to experience greater investment risk going-forward. Since many investment models and numerous asset allocation software programs focus on risk and return statistics for 5yr and 10yr time periods, investors could easily underestimate portfolio risk stemming from long-term bond investments.

Meanwhile, the market cycle in stocks and the relative "value" opportunity in emerging markets over US markets could raise portfolio risk. By almost any measure, US stocks are running moderately above normal valuation and several models suggest that forward-looking returns for emerging market economies could be substantially higher than their developed-nation counterparts.

A typical allocation model might suggest offsetting the bond "problem" with investments into other assets, including real estate, commodities, and developed and emerging market stocks. The main thesis and takeaway from this commentary is this: whether an investor decides to stick with a current stock-to-bond ratio or decides to increase stocks and reduce bonds, portfolios are likely to experience a fairly substantial increase in volatility.

If an investor is willing to take on more volatility, then rewards may lie in emerging regions around the world and in new innovation and technological breakthroughs in the US. However, most investors have already determined the risk exposure they can tolerate, so an increase is portfolio volatility due to bond risk and/or due to emerging market investments, should be offset by reductions in the risk profile of other allocations.

Here is a quick summary of the situation:

- Bonds are likely to experience higher volatility going forward (especially long-term bonds and bond funds).
- Emerging market stocks are cheap, but have historically been more volatile than almost any other asset class.
- US stocks are the default investment, benefitting from Fed actions and a lack of quality investment alternatives. But they are moderately over-priced relative to historic averages.

MITIGATING RISKS AND ALLOCATING CAPITAL

Awareness is the first and important step toward solving any problem. In this case, the awareness of higher volatility can provide a framework for allocating capital. Another important step is research. Investing is an activity seeking gain. Research can provide an essential element in understanding the risks of any specific investment. Research can also provide a framework for a thesis: A working model for capital allocation.

If interest rates are expected to move higher, then what investments benefit from rising rates? If stocks are not cheap (as a whole) but certain companies are still innovating, then research can uncover opportunities within an asset class.

With higher potential volatility, portfolio construction is even more important. The ice cream and hot chocolate product mix is negatively correlated and reduces seasonal risk for the shop owner. The same is true of an investor portfolio. Focus on pairing investments that are negatively correlated to certain market forces.

A core and satellite approach is particularly appealing in this environment. The core holdings are securities that have a high degree of certainty and help anchor the portfolio while the satellites are allocations designed to offer higher returns and timely opportunities. A US large-cap value core may be paired with emerging market stocks, commodities and smaller innovation company satellites. A US investment-grade bond core may be paired with high yield bond, real estate investment trust or energy pipeline revenue satellites.

Typically core and satellite allocations are constructed in a ratio similar to planets and moons (hence the name). The planet (core) is the more substantial capital allocation while the moons (satellites) are smaller strategic investments.

Another important capital allocation objective in the current environment is to achieve diversification within the core assets. For most investors, US large company stocks represent the largest asset class weighting. Within this asset class, it is necessary to have exposure across many types of companies. It's essential to go beyond the simple "value" and "growth" delineation. Again, some core holdings can be matched with satellite exposure. Most core holdings in the US market can be classified as world dominators (proven brands with reliable business models - Example : Wal-Mart) and mature growth (businesses with great brands and slowing growth - Example: Apple).

Quality satellite ideas could come from the class of "innovators" and "turn-arounds." On the front end of the business cycle, innovators offer the potential for early stage growth (which often exhibit the biggest price gains) and for late stage corporate "reinvention and renewal." Innovative winners have historically offered very good returns for investors. Typically, innovators are in information technology, biology, chemistry and health care. Turn-arounds can come from any company that has already gone through its innovation stage, grew to maturity and then faded. In the 1990's IBM was able to turn itself around and investors were rewarded handsomely. Current innovators include three dimensional printing, nanotechnology and new treatment of diseases.

Portfolio volatility could be on the rise. Be aware of the possibility, create a thesis around potential outcomes, research ideas that could be expected to perform well in the scenario, and allocate capital accordingly. Diversify across opportunities.

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