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EXTRAORDINARY TIMES

Managing Market Volatility and Engaging with Clients

An edited transcript of an Exceptional Advisor Webinar with Todd Wagenberg, CIMA®, Scott Welch, CIMA®, and Brian Ullsperger, CIMA®, AIF®, AAMS®, CMFC®, moderated by Tony Davidow, CIMA®

INVESTMENTS & WEALTH INSTITUTE®

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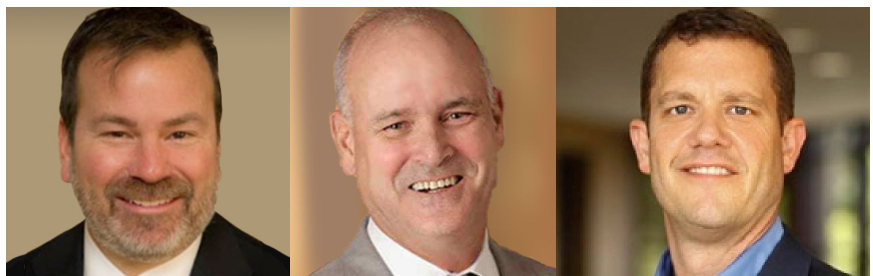
Editor's note: The following is an edited transcript of a May 7, 2020, Investments & Wealth Institute Exceptional Advisor Webinar focusing on market volatility and how advisors are talking with clients in these extraordinary times. Participants were three Investments & Wealth Institute board members: Chair Todd Wagenberg, CIMA®, managing partner, Integrated Fiduciary Advisory Services; Treasurer Scott Welch, CIMA®, chief investment officer–model portfolios, WisdomTree Asset Management; and Board Member Brian Ullsperger, CIMA®, AIF®, AAMS®, CMFC®, managing director, Andersen Investment Advisory. Investments & Wealth Monitor *Editorial Advisory Board Chair Tony Davidow, CIMA®, president of T. Davidow Consulting, moderated the discussion.*



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Davidow: Today we'll delve into the challenges facing you and our clients. Scott, what are you telling clients now?

Welch: I looked up a quote from John Bogle in anticipation of that question. It's three words: "Nobody knows nothing." This is an unprecedented time—an unprecedented market decline followed by a huge rally. Who knows where we go from here?

If I was to project, keeping in mind that nobody knows nothing, I think we're bottoming out. I think the second quarter is a wipe out. Earnings and economic growth are going to be horrible. I'm no medical expert, but it feels like the pandemic is bottoming out to some degree, though people are still going to get sick.

But I think that the speed with which the Fed responded and the magnitude with which the government responded on the fiscal side is unprecedented. And all that money has to go somewhere. I don't think we're going to come out of this in a V shape, which some people are projecting. But I also don't think it's going to be an L shape, which other people are projecting. I think we're going to start getting better slowly in the second half of the year. Given the amount of both monetary and fiscal stimulus we've seen, I think it's going to be an okay environment for the market.

Davidow: Todd, you have individual and institutional clients, and the discussion with institutional clients is often different than with individuals. Can you discuss how you've been engaging your boards?

Wagenberg: I typically speak with my institutional clients monthly and have formal quarterly meetings, so it's not like we're waiting every quarter to talk and make adjustments. We were a bit hesitant about the markets going into the end of the fourth quarter; we thought things had been running a little hot. We were okay erring on the conservative side, but with these huge moves you have to rebalance based on the investment policy statement (IPS). We monitor that for every one of our clients. In March, we got to certain levels, and so we made rebalances.

What we didn't do, though, was rebalance back to target with all our clients. Every client, whether institutional or individual, has their own risk tolerance. And it takes a good move like this to really find out whether the investment policy and the risk assessment in place are acceptable to the client. Fortunately for us, our institutions have been open to the rebalance. Like Scott's saying, nobody knows nothing, but you have to stick to the policy statement. We all learned in the CIMA program that the most important thing for investing is a pertinent IPS that's relevant to your client. If it's relevant in good times, it should be relevant in bad times as well.

Davidow: Brian, you've consistently said we shouldn't depart from what we've always done with our clients, even going back to basics. How are you engaging your high-net-worth clients and how are you bringing them back to basics?

Ullsperger: Advisors who believe in asset allocation, we're contrarians. To Todd's point, in the early part of the year, with new highs almost every day, the contrarian reaction was: Something's coming—there's going to be a shock. But shocks are always out there—we just don't know what, when, how long, how deep.

We've been doing what we've always done, our three Rs. First, we reassess goals and objectives. What are our clients trying to accomplish? What is their time horizon? How much risk are they willing to experience? Second, we review the portfolio, the asset allocation and holdings. Is the asset allocation managing overall risk, and are managers adding value (upside and downside protection)? Lastly, we rebalance back to target, or close to target, allocation.

That is a process we do over and over again, and it's not time to abandon that now.

Davidow: Brian, we know that clients are driven by emotions. How are you grounding them in the process and keeping them from reacting emotionally?

Ullsperger: A bull market makes everyone an aggressive investor, and in a bear market, everyone's benchmark is cash. The first thing we should do as advisors is be empathetic. This is a brutal market environment. It's critical that we listen to our clients and address their fears and concerns, because they are real. This is an economic crisis and a health crisis, so be empathetic and do not dismiss concerns. If you try to sugarcoat what's happening, I don't believe you're going to deepen your clients' trust in you or your team.

Davidow: I love the term "empathetic advisor." I think it's phony to suggest "everything's fine," because clients know it's not fine, and it's more difficult to make portfolio shifts with institutional clients. Todd, what have you been communicating to your boards about markets and their portfolios?

Wagenberg: It depends. We have pension plans, which have much different expectations and concerns than foundations. Foundations tend to be a bit more emotional. I think we've been lucky and we've prepared our clients properly—we know this is going to happen at some point. Most of my clients have been around since 2008 and 2009, some from 2001 to 2003. It is about talking about the downside, knowing that it's going to happen, and when it happens, being prepared to take advantage of it and move in and rebalance. Every one of my institutional clients understands this.

You know, it's kind of weird, in 2008–09 it was different. Now is more of a health concern. You find out that money is the number-one concern until you have a health problem, then health becomes the number-one concern. So, I think it's been easier for clients to go back to the IPS and be more robotic in terms of rebalancing back to targets.

To pick up on something Brian said, what's really important now, almost more than rebalancing, is making sure everyone knows why every asset is in that portfolio and making sure those assets are performing. They may not be doing well but as long as they're not doing well for the right reasons, that's okay. When things aren't working the way you were expecting them to work in a situation like this, then you have to take a deep dive into that asset, into that manager, and find out what's going on and clean things up.

The big thing is to keep clients educated. As long as everyone knows why you're doing certain things, they will understand.

Davidow: Scott, what are you saying in your blogs? How are you helping clients navigate this noise?

Welch: It comes down to two broad themes. First, advisors as well as investors tend to get paralyzed over this kind of market volatility. But we're telling people to lean in, because here's an opportunity to do things that perhaps inertia prevented them from doing when markets were going straight up. For example, this is a perfect time to be (1) tax-loss harvesting, (2) reviewing asset allocation and making sure it's aligned with long-term objectives, and (3) determining if now is the right time to get cash off the sidelines and back into the market. Advisors can do a variety of things right now that add tremendous value for clients.

Second, it is all about time horizon. Generally speaking, if you lengthen your time horizon enough, the market goes up. I empathize with investors who may be near retirement or are living on a fixed income and saying, "Oh my gosh, am I going to be able to keep going?" But the truth is this is going to get better. We are going to find therapeutics and a vaccine, and we have put so much money into the system that the economy will recover. I don't know what that looks like, but we're coming back from this in some way, shape, or fashion, and the market's going to come with it. In fact, the market's probably going to precede it.

So, the two broad themes are: (1) lean into this volatility and take advantage of it, and (2) educate your clients, or re-educate your clients, that now is not forever. Things will get better.

Ullsperger: To add to what both Scott and Todd shared, a lot of clients are asking, "What's going to happen?" None of us know in the short term. To make a prediction over the next 3, 6, or 12 months is gambling. When investing, I'm very comfortable talking about the next 8 to 12 years, it's been proven over time that markets do indeed recover. To echo Scott—and I think it's a great way to say it—if you can lean into risk, you can make tremendous profits. I know it's hard to be optimistic in a brutal situation where we're all sheltering at home. But from an investment standpoint, there is reason to believe this is the best time to be investing. In fact, the best time was March 23.

Davidow: When markets bottomed on March 23, clients felt maximum pain and temptation to get out of the market. But we know if they leave, it will be difficult to get them back in at the right time.

We've been talking some about the death of the "60/40" portfolio. It's worth remembering why 60/40 became popular in the first place. Institutions began benchmarking to the 60/40 portfolio expecting 60 percent in U.S. stocks would provide growth (10.3-percent long-term historical average) and 40 percent in bonds would provide desired income (4–5 percent over the long-run). However, today that math doesn't work. Equity returns will likely be lower, and we know that bond yields are at all-time lows.

Brian, how are you thinking about the 60/40 portfolio? And what sort of asset classes are you using in your portfolios to solve for today's environment?

Ullsperger: From a core-belief standpoint, I believe in asset allocation. I believe over long periods of time, equities will outperform bonds, bonds will outperform cash, and alternative strategies, which should be incorporated into portfolios—and we can debate what those alternatives look like—should outperform bonds and provide a more consistent return stream than equities.

How you mix and match investments becomes your asset allocation. Now, we again find ourselves in a historically low interest-rate environment. It is hard to buy 10-to-15-year bonds because rates are so low. Where do we find other kinds of fixed-income-like returns and consistency? Real assets? Managed futures? Long-short strategies? Event-driven strategies? All can have a place in the portfolio once you decide on the broad asset allocation. And within equities, it has to be a diversified pool of investments that includes emerging and international strategies.

In your defensive bucket, how do you blend in fixed income, alternatives, and low-correlated vehicles to provide diversification? If we were in an environment like the dot-com era where you could get 7–8-percent muni bonds, or 2006, 2007, when you could get 5–6-percent, I'd tell you to load up now, but those are gone. Which is why we need to think about what tools fit into that bucket.

Davidow: We all believe in asset allocation, but I think we need to evolve our approach. Scott, how would you respond to Brian's comments?

Welch: I'd like to make two points. First, I wrote a blog recently called "In Defense of the Endowment Model (Again)." I wrote an article with the same title for the *Monitor* in 2010, when the endowment model went out of favor after the financial crisis because a lot of universities landed in a liquidity squeeze and everybody said, "You're not as smart as you think you are." Since then, we've had this great central bank rally where if you had anything besides stocks and bonds in your portfolio, you underperformed.

As a result, the endowment model fell to the side of the road, but what I've recently seen and heard from advisors is an increased interest in less-correlated assets. That could be real assets; it could be alternatives. But just the idea of incorporating things that are less correlated to stocks and bonds is of growing interest and importance to advisors and their investors, versus last year when the market went straight up.

Second, the current dividend yield is higher than the current bond yield, and it has been for a while. It's not normal, but here we are, and we expect it to continue. Simplistically, investors have three primary objectives: (1) maintain a current lifestyle, (2) make sure they don't run out of money before they die, and (3) optimize taxes and costs.

In a 60/40 portfolio, generating income out of that 40 percent in today's rate environment is a tough row to hoe. You can take increased duration risk or increased credit risk, but you get to the point where you're defeating the purpose of having the bonds in the portfolio as a hedge to your equity risk. So, take what the market is giving you, and right now it's giving more in dividends than in bond yield.

If I was building today's 60/40 portfolio, I'd load up on dividend- and yield-focused equities and focus on quality on the fixed-income side to maximize current yield. That also improves the longevity profile of the portfolio. If I have a portfolio that's more heavily allocated to yield-focused equities—let's call it 75/25—and I'm living longer, which most of us are, pandemic aside, then I have improved the current income aspect of my portfolio and I've improved its longevity profile as well. Today's 60/40 might not look like yesterday's 60/40.

Davidow: That's a fair point. Todd, please discuss the role of alternatives in today's environment.

Wagenberg: On the whole 60/40 conversation, I'm probably more of a dinosaur than these other guys—I still believe it will work. It comes down to expectations. The market's only going to deliver a certain amount of return, even if you want to dress it up with illiquid alternatives that haven't really been doing what they should be doing. The thing with the 60/40 portfolio, you're not getting income off the 40 but you still have the liquidity of the 40 and when you have a chance to rebalance, you need to take it from somewhere. You're not going to be able to take it from private equity or real estate or anything illiquid because it takes too much time to get your money out.

A 60/40 portfolio might not be as sexy as some of these other investments, but it's working. I remember hearing of the death of the 60/40 back in 2007; rates were dropping back then as well. If the market's only giving you a 3–4-percent return on the 60/40, you have to learn to live with that. Taking risks that you're not aware of is not a good strategy to achieve a 7- or 8-percent rate of return.

Private equity investments are available and interesting, but pricing is difficult. You really don't know what the investment is worth until you sell it. It's not liquid, so you better know what you're doing and be sure your allocations are appropriate for your client. It all comes back to expectations.

At the end of 2019, we were looking at the 10-year S&P rate of return averaging about 15 percent a year. You can't expect that to go on forever. If you believe in reversion to the mean, you're going to be lucky to get 5 percent over the next five years. Averages ebb and flow. We're all professionals, it's about staying disciplined. Making changes on the margins is okay, but you better be careful about making wholesale changes to any portfolio.

Davidow: So, Todd, I want to push back a little and ask you to address Brian's comment about income. Where are you finding income?

Wagenberg: I would say that your S&P standard deviation is much higher than your bond standard deviation. The income question is very interesting because what we've been trying to do—and it's not easy—for the past five years is find uncorrelated, income-producing assets. Real estate is obviously one. I have a feeling there will be a delayed reaction to asset prices in this class. Real estate on a conservative portfolio will give from 5 to 6 percent. Distressed debt is an asset class we're starting to look at. I think the second half of 2021 will present plenty of opportunity, especially when government programs slow down.

We are constantly looking at different investments. Private credit was interesting until it became a very crowded space, which makes me nervous. A lot of cash is sitting on the sidelines. We're in it for the long haul, everyone is, and it's about setting expectations.

During the fall-off in March and April, we told clients we're nervous about these markets, so we are going to take advantage of it through rebalancing and holding extra cash for new opportunities. I agree, you're not going to get the income from fixed income, but just because someone needs a certain amount of income doesn't mean that it's available. Warren Buffett was asked what do you do with 1-percent interest rates, and he said, "You learn to live on 1 percent."

Davidow: Scott, how are you thinking about alternative investments? Which particular strategies should do well in this environment?

Welch: First, I haven't given up on alternative strategies, but I've been disappointed in them for a long time. The bulk of liquid alternatives came out after the great financial crisis, and everybody piled in because liquidity was at a premium. They liked the idea of long-short or managed futures or event-driven, or whatever, but they wanted liquidity.

So, when asset managers developed their products, they built them to be very low-volatility products, which is fine, but we've been in a very low-volatility environment until recently. The returns for a low-volatility product when there is no volatility are going to be exactly what you expect. Historically, back in the hedge fund world, those strategies worked best in a market environment of rising rates and increasing volatility, where active management can succeed. We haven't been in that environment for 10 years, until maybe now.

So I haven't given up on alternatives, but I do think that, at least in the liquid space, the strategies most likely to succeed don't require too much leverage or too much illiquidity. Some of those strategies that are available primarily in hedge fund or limited partnership form—that's how they make their money. They take on illiquidity and leverage. That's a perfectly legitimate way to make money, but for liquid alternatives, I think you need things that don't require those two characteristics to succeed.

Second, if I'm looking at a diversified basket of alternatives, I'm looking for cash plus 3–4 percent, with half the volatility of equities. If I can get that, that's a success. But in an environment where cash is zero, you're looking at a 3–4-percent return. That doesn't excite anybody, but I've met my expectations.

Ullsperger: Scott hit on a key point: Those investments came out after the financial crisis. Everyone said, "Oh, now I want to invest in alternatives." Well, it's after the fact. That is chasing returns. In fact, they may have wanted to look the other way, whether it was bonds or long equities, and I think of it as similar to now.

I'll use a very specific example—investing in managed futures. The great debate about managed futures isn't today, it was a year and a half ago. If you believed in the asset class and had conviction to invest, it looked horrible. It was losing money, it wasn't performing anywhere close to equities, and the bull market was running wild. But that's the time to make that investment, because of what's coming. Whether it's managed futures, real assets, long-short, or hedged, you have to look at all those things and plan ahead.

Right now, I think the bigger debate is not alternatives versus fixed income but whether active outperforms passive. This environment will be stock by stock, sector by sector, and identifying managers that can identify high-quality companies to buy and have the courage to be different from the index. That can add a lot of value in portfolios.

Wagenberg: A lot of the problem with alternatives is that people put them in portfolios without understanding why. Managed futures is a great example. Managed futures did well in the late 1990s and early 2000s, but a lot of people don't realize why. Managed futures are a levered position, so you're carrying cash as collateral. The return on your cash becomes a significant factor on return. As money market returns declined so did the average returns on the class, and suddenly carrying costs of managed futures became more expensive.

It's important to understand what you own and why you own it. So, you own managed futures for volatile periods. When volatility is low and interest rates are low, your opportunity cost will be high. That's okay as long as you understand that. But advisors buy these assets and don't understand how they work, and then they have a problem.

Davidow: Todd, you're right that not all alternatives are created equal. Managed futures is a perfect example. It was one of two positive asset classes in 2008; it was up 10 percent. The other, of course, was cash. Managed futures is a trend-following strategy, and it worked well in that environment.

Welch: Remember, this whole conversation is about managing volatility. And that's what these strategies are intended to do within the context of a diversified portfolio. You don't buy alternatives because you think they're going to outperform everything. You buy them because they have lower correlation to stocks and bonds, and therefore when you have a volatile market environment, you have a little more consistent performance, maybe a little downside risk mitigation, which is what you want.

The trade-off—and this is what we've experienced over the past 10 years, frankly—is if you have that in your portfolio and the market goes up, you're probably not going to keep up. So it's back to Brian's comment about educating your clients, and Todd's point about making sure they understand what they have in their portfolios and why.

Now that we are working from home, the question is: Is the work-from-home environment accelerating? If so, what happens to office space? Retail space? It's easy to say, "Everyone's going to be working from home and no one's going to lease any office space."

Davidow: Earlier, we started talking about income. Where do you get income in your portfolios? Are you considering alternatives sources (e.g., real estate investment trusts [REITS], master limited partnerships [MLPs], etc.)?

Ullsperger: I think REITs are one of the most uncertain investments and asset classes. Now that we are working from home, the question is: Is the work-from-home environment accelerating? If so, what happens to office space? Retail space? It's easy to say, "Everyone's going to be working from home and no one's going to lease any office space." I don't know if I'd go that far, but I do think there will be challenges.

Davidow: I would point out that MLPs are highly correlated to the energy sector.

Ullsperger: One thing that's lost in the shuffle around coronavirus is that we had a major oil price war at the beginning of the year that blew up an industry. And I don't think we have begun to deal with that issue because it's being masked by the other things going on.

Wagenberg: To add one thing about MLPs and REITs, this is where you get in trouble reaching for yield. Advisors think this is a fixed-income offset, but it's nothing like fixed income. I would say industrial REITs are more attractive than retail REITs, without question. But you want to know what kind of lever is on these things. MLPs can be highly levered and when they're not working right, they're done. The same thing happens with business development corporations. It's all highly complex financial instruments created to allow owners to borrow heavily, making a lot of money when they're working, but leaving investors holding the bag in times of stress, so you better be aware of what is in your portfolio.

Welch: Brian and Todd raised a couple of interesting points. First, one original attraction of real estate and MLPs was their lack of correlation to the broader stock market. But once you equitized them by turning them into mutual funds or exchange-traded funds, correlation to the stock and bond markets skyrocketed. So, if you're putting those things into your portfolio, just accept that you're not getting the correlation benefits you might have gotten historically.

Yes, you're going to get enhanced yield. But in a market where everybody is looking for yield, those things are expensive. I don't like the leveraged loan space right now, because leveraged loans are basically collateralized loan obligations. The banks don't hold the positions; they underwrite the loan, they syndicate it out, and then it's off their books. As a result, covenant structures have deteriorated. Remember, these are unrated companies.

So, if I want to engage in middle-market lending, I prefer the private market, because those folks do intense due diligence. They turn down way more loans than they say yes to. Yes, a lot of cash is sitting on the sidelines right now. But if I'm going to do middle-market lending, I'm going to do it in a private space versus a public space if I can access it.

I am not a tactical investor, but if you asked me to take a 6–9-month bet, I think high yield and investment grade looks pretty good. I think the spread compression we're going to witness over the next six months will exceed any rate increases, so I think there's money to be made in the public bond space.

Wagenberg: And I would just add, it's helpful that the Federal Reserve is on the bid of the bonds market.

Welch: The phrase "Don't fight the Fed" exists for a reason. If they're buying it, so should you.

Wagenberg: And that's really holding up this market. As soon as the Fed started buying corporate bonds, the equity market firmed up. As long as publicly traded companies have access to cash, there's no problem.

Davidow: What about gold as an asset class?

Wagenberg: We just implemented a gold position across our entire client base. We made a small allocation from fixed income into gold. Historically I'm not much of a gold fan. The cost to carry is not that large relative to what I'm missing in my short-term bonds. I could make the argument that we're headed into a deflationary environment, or I could make an argument for inflation. Historically, gold has performed in both. In the deflationary 1930s, gold did well, and in the inflationary 1970s and 1980s, gold did well. Monetary printing presses are on full bore around the world, so you can argue gold is probably not the worst thing you could buy right now.

Welch: I'm fortunate to sit on a lot of investment committees of different advisory firms, and almost every one of them is considering or has added gold. Where there's no yield to be had on the income side, you're not losing anything by holding gold versus bonds. I've never been a gold bug, ever, but I like it right now.

Davidow: What are your thoughts on international and emerging markets (EM) considering the weakening dollar?

Ullsperger: I'm probably way ahead of that trade, but it goes back to believing in asset allocation and being a contrarian. We've been tilted toward international stocks for years and it hasn't paid off. That's an honest answer.

Other countries have seemed to handle this crisis better than the United States and may be opening faster. There may be opportunities for other countries (and companies) to work together. That may drive their economies, their countries, and their companies faster.

Lastly, from a valuation standpoint, it's hard to ignore how cheap EM stocks are, given current valuation compared to U.S. stocks. Maybe this is when international stocks assume market leadership.

Welch: I agree with Brian on the valuation question, but we've been making that argument for a long time and it hasn't really worked. Every firm I work with has a healthy allocation to non-U.S. in their model portfolios. We're a bit underweight developed international right now and bit overweight EM. Historically, coming out of recessions in the United States, EM has done very well relative to the U.S. market. So, if you believe we're going to come out of this recession, I'm bullish on EM.

Wagenberg: EM is a four-letter word to me. So is AWCI ex-U.S.[1] I have an allocation to international equities, with an overweight to EM relative to developed. I am significantly underweight on both asset classes to U.S. equities. I prefer active management in emerging markets. I believe active management has delivered significant alpha over passive in this space.

Davidow: Thank you gentlemen. This discussion is exactly what we envisioned for the EA Webinar Series—timely, relevant, and actionable advice. I encourage members to take advantage of this exceptional series designed specifically for you. To learn more, please visit https://investmentsandwealth.org/online-catalog/virtual-events.

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ENDNOTE

1. The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International and comprises stocks from 23 developed countries and 24 emerging markets.

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