Fourth Quarter 2024

Risk On, Risk Off Investment Strategies

Portfolio diversification and fixed allocation investment strategies such as Modern Portfolio Theory's 60% equities 40% bonds portfolio have taken a beating in the financial news the last two years. The 60/40 portfolio had one of its worst years in 2022 when bonds tanked as a result of the rapid increase in interest rates by the Federal Reserve. In 2023, a 60/40 portfolio based on the FTSE Global All Cap Index and the Bloomberg U.S. Aggregate Float Adjusted Index(1) would have lagged the S&P 500 Index(2) by 46% while diversified portfolios struggled to match the Artificial-Intelligence-turbo-charged S&P 500.

But both investment strategies are doing exactly what they were designed for – minimizing risk.

Diversified portfolios hold investments designed to offset losses in one asset class by gains in another, reducing the risk of a total portfolio meltdown. As a result, a portion of the portfolio is typically underperforming higher return assets, making it unlikely the overall portfolio will mirror index returns such as the S&P 500. This is good in market downturns but discouraging in rising markets. The cost of reducing risk tends to be reduced returns over the long term but also reduced portfolio volatility and smaller drawdowns in declining markets.

That doesn't mean investors passively accept lower returns. Perhaps the most common complaint investment advisors hear is "Why is my portfolio underperforming the S&P 500?"

The same critics of diversification and 60/40 portfolio theory will quickly point out that other investment tactics also fail:

- market timing doesn't work because no one can successfully predict market tops and bottoms,
- superior stock selectors are so rare as to be almost nonexistent,
- mutual funds and ETFs are more likely to underperform than outperform the S&P 500,
- technical analysis is fallible,
- individual investors tend to buy high and sell low,
- and that, all in all, humans are not very good investors.

Stay Calm, Carry On Investing

Before you throw in the towel on investing and decide your only option is to ride out the S&P 500's volatility, it helps to step back and think why you are investing, what you need to achieve, and how you might be able to maintain the confidence to invest for the long run.

Investing at its most basic is buying ownership shares in a business so you can share the rewards of its growth or loaning money in exchange for the return of your principal and a known interest rate. It's a means of making money from your savings to keep up with the erosion of inflation and taxes so that you will have more money when you need it. How much money you will need depends on how much you have to invest, your time horizon and the volatility of the financial markets over your investing horizon.

The problem with trying to anticipate future returns is the human tendency towards extremes, creating cycles where economies, asset values and inflation move from highs to lows and back again. There's also a dismaying tendency towards starting wars and the reality that disasters can happen, wiping out a significant portion of the value of our investments. For many people, the pain of losing not just money, but the plans they had for that money, stops them from investing in the market for months and sometimes years.

Insurance is one means of limiting losses on hard assets and one's life. We have home insurance, auto insurance, personal property insurance, health insurance, life and disability insurance, etc. While

investments such as rental property can be insured, portfolio insurance is a different matter. Every insurer knows that the odds of the entire market falling 25% or more roughly every five years are pretty high.

Active investment strategies ask how do we reduce the risk of crippling market losses and keep clients invested for the long run?

Risk On, Risk Off is one of the tools to do so. Risk On is taking greater risks in pursuit of higher returns. Risk Off is when we prioritize capital preservation and avoid higher risk investments.

Historically, investor sentiment has been one of the key determinants of how willing investors are to take greater risks or to protect their capital through lower risk investments. Today, Risk On, Risk Off decisions are far more likely to be based on fundamental and technical market indicators. One of the more exciting applications of Artificial Intelligence (AI), is the ability to analyze prior markets and look for common indicators preceding changes in market direction. The same indicators can then be used to monitor current markets for similar patterns and discover new patterns. It is true that markets never follow precisely the same pattern, and global factors are always changing, however, there tend to be recuring behaviors in market cycles that indicate increasing risk.

As indicators signal increased risk, the portfolio moves to a Risk Off allocation. When market indicators are positive, Risk On becomes the allocation driver as the portfolio takes on more risk in its investments.

While it is impossible to predict turning points in markets, it is possible to monitor for signs of risk and adjust portfolios in response. If, by moving to a more conservative portfolio and muting the impact market downturns, drawdowns are reduced, the portfolio has greater leverage (i.e. more money) to profit from market recoveries.

Investors cannot invest directly in the indexes mentioned in this article. Diversification, asset allocation strategies and risk on risk off strategies do not ensure a profit and may not protect against losses in a declining market.

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1. The FTSE Global All Cap Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the market performance of large-, mid-, and small-capitalization stocks of companies located around the world. The index includes approximately 7,400 stocks of companies located in 47 countries, including both developed and emerging markets.
The Bloomberg U.S. Aggregate Float Adjusted Index is an unmanaged benchmark representing the broad, investment-grade U.S. bond market. The fund invests in taxable investment-grade corporate, U.S. Treasury, mortgage-backed, and asset-backed securities with short, intermediate, and long maturities in excess of one year, resulting in a portfolio of intermediate duration.
2. The S&P 500 Index or Standard & Poor's 500 Index is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S.

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