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Process Beats Prediction

A Whitepaper by Innovest

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Unprecedented swings in the stock market mightily tested investors in the great market crash of 2020. After making an all-time high on February 19, the S&P 500 dropped 34% in 32 days, the fastest 30%+ decline from an all-time high in over 90 years. This crash was followed by the fastest move to the upside since 1933, a gain of 25% in four weeks.

Forecasters have not been shy about making predictions when giving guidance to investors. Forecasting is never easy, and predictions are usually wrong. Goldman Sachs's predictions following the meltdown are not only contradictory, but almost comical.

Headlines:

***'Goldman Says the Market Has Not Bottomed'* –** Finsum (31 March 2020). Retrieved from Nasdaq https://bit.ly/3kdhEOX.

***'Goldman Sachs Says We Saw the Bottom, Here's Why'* –** Finsum (13 April 2020). Retrieved from https://bit.ly/2XutcUi.

***'Goldman Warns of an 18% Stock-Market Drop as Coronavirus Cases Steadily Rise'* –** MarketWatch (12 May 2020). Retrieved from https://on.mktw.net/31dSK9o.

In reality, the low point for the U.S. stock market was March 23, 2020, and as of August 31, 2020, its largest subsequent pull-back has been -7.1%. Goldman has a dismal track record of making consistently accurate calls!

Headlines

The more sensational the prediction, the more likely it will be covered by the news media – print, television, and social media. An outrageous prediction is often accompanied by a hyped, supposed solution to their prediction. In other words, forecasts are usually followed by a product sale.

Does saying, "I don't know," suggest uncertainty or does it suggest humility? We would suggest that humility is an important trait of a successful investor. In her review of the research paper "Cognitive and Interpersonal Features of Intellectual Humility," Allison Jones of *Duke Today* observed the following:

> *"…(I)ntellectual humility is the opposite of intellectual arrogance or conceit. In common practice, it resembles open-mindedness. Intellectually humble people can have strong beliefs, but recognize their fallibility and are willing to be proven wrong on matters large and small…"*
>
> \- Allison Jones, *Duke Today*,
>
> March 17, 2017

The successful alternative to intellectual conceit and making predictions is intellectual humility and an ongoing commitment to managing investments with a systematic and proven course of action.

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Process

A common link that separates great athletic programs from merely good ones is process. Great programs are like a well-oiled machine. Quality training and conditioning, appropriate nutrition, drilling with attention to detail, proper sleep habits, mental strength coaching, goal setting, and team building, culminate in success. The process must be consistent, disciplined, and intense.

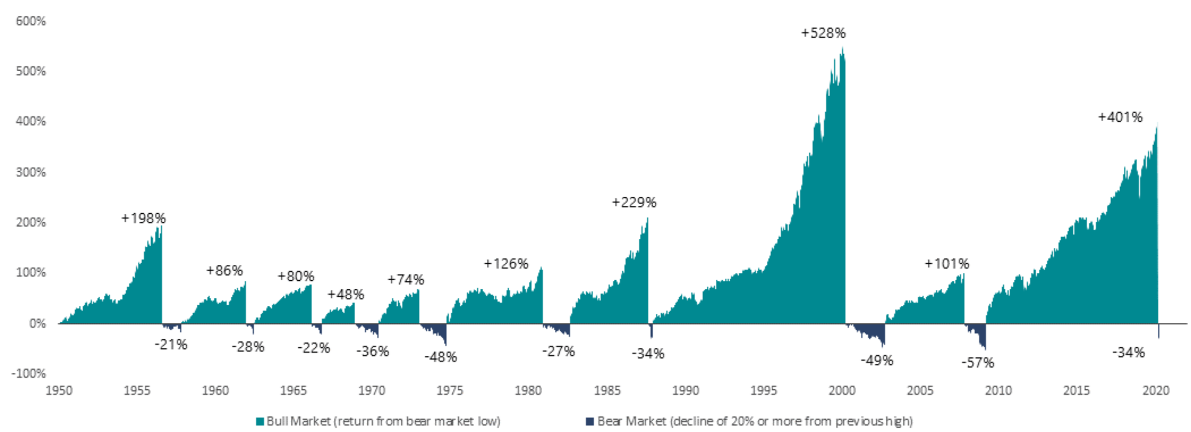
A successful investment program is no different. The common link to all successful investors is that they are process oriented. Fiduciary law grasps *process* as the sound approach to managing investments because it is time tested and proven. There are a number of successful processes that are likely to generate better results for investors, institutions and high net worth families alike:

Embrace Rebalancing

Timing markets successfully is a fallacy. The length and breadth of bull markets overwhelm the depth of bear markets. Exhibit 1 below demonstrates the point.

Exhibit 1

Bull and Bear Markets in U.S. Stocks since 1950



- Neither bear markets nor bull markets last forever.
- Bull markets since 1950 have tended to last much longer than bear markets.
- The most successful investors maintain their focus on the long-term during market pullbacks and remain disciplined through portfolio rebalancing and looking for opportunities.

Sources: Litman Gregory and Morningstar Direct as of 3/31/20.

The most successful investors maintain their long-term focus during market pullbacks and remain disciplined through portfolio rebalancing and looking for opportunities. For a stock market investor there is a much bigger risk of being out of the market than in the market. Timing the market is impossible, and not being a participant in the rebound can be devastating to returns. Exhibit 2 examines

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historical returns following the worst bear markets. On average, stocks returned over 50% a year later, and 132% over the next five years.

Exhibit 2

Forward Returns After the Worst Bear Markets

			Forward Returns	
Drawdown	Peak	Trough	1 Year	5 Years
-86.2%	9/7/1929	6/1/1932	162.9%	344.8%
-56.8%	10/9/2007	3/9/2009	53.6%	181.6%
-54.5%	3/6/1937	3/31/1938	35.2%	84.5%
-49.1%	3/24/2000	10/9/2002	24.4%	105.1%
-48.2%	1/11/1973	10/3/1974	38.1%	117.5%
-40.6%	9/7/1932	2/27/1933	98.7%	154.6%
-36.1%	11/9/1968	5/26/1970	34.7%	42.4%
-34.5%	11/9/1940	4/28/1942	61.2%	144.9%
-33.5%	8/25/1987	12/4/1987	23.2%	121.7%
-31.9%	10/25/1939	6/10/1940	8.0%	118.8%
-31.8%	2/6/1934	3/14/1935	83.8%	84.9%
-29.8%	7/18/1933	10/21/1933	2.9%	87.3%
-29.2%	2/19/2020	?	?	?
		Averages	52.2%	132.3%

As of March 18, 2020. Source: Ben Carlson and awealthofcommonsense.com.

The most common advice during bear markets is "be patient and stay the course." While that approach can be helpful, it does not go far enough. Rebalancing a diversified portfolio will enhance returns and shorten the time frame to a full recovery. The study (Exhibit 3) below demonstrates the point.

Rebalancing Study

Innovest performed a study which quantified the benefits of portfolio rebalancing. While there are various approaches, we used a common range-based approach, which is successfully used by many institutional investors.

We modeled a 60% S&P 500 / 40% Barclays Aggregate Bond portfolio that would be rebalanced back to the strategic target when the portfolio's allocations deviated + or – 3% from their targets. The first of the two time periods examined was from August 1998 through September 2005, a period of just over seven years. This time period encompassed the three years leading up to the 2000 Tech Bubble market peak, the subsequent bear market when stocks lost nearly 50%, and the first three years of the ensuing bull market. Shown in Exhibit 3, the portfolio employing rebalancing resulted in a faster recovery, and overall increased return of 1.07% per year over the three years following the bottom of the market drop.

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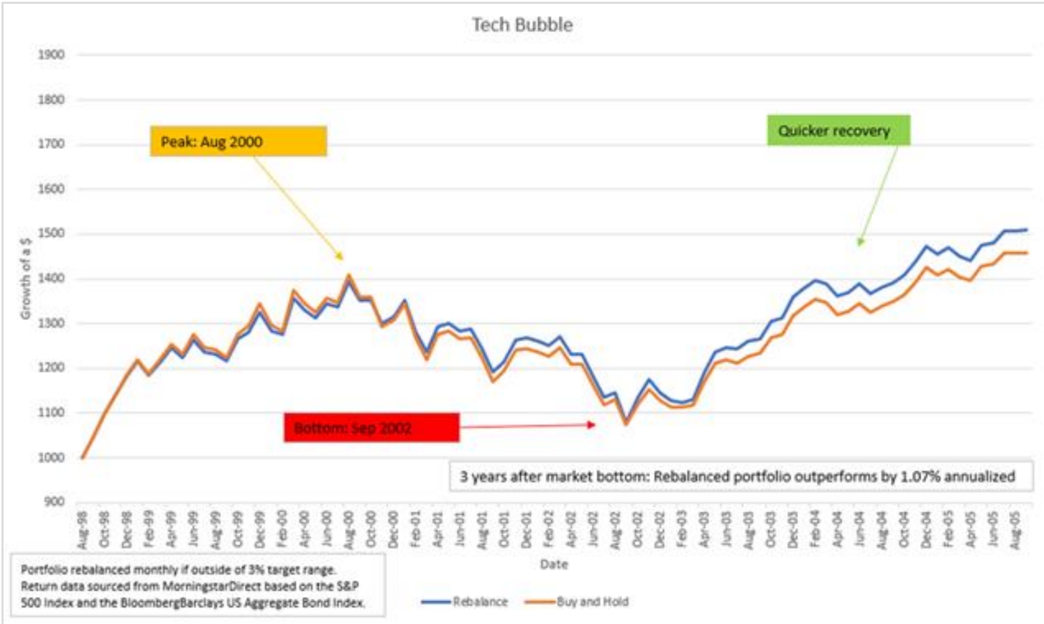
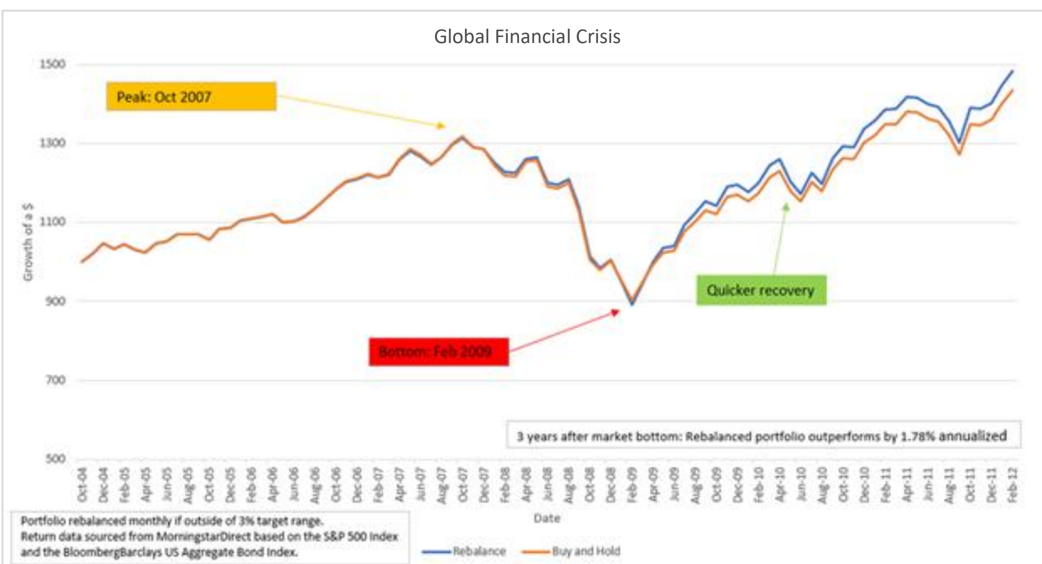
Exhibit 3



The second time period examined, from October 2004 through February 2012, used the same timeframes of leading up to a market peak, a bear market, and the first part of a new bull market. In this case, the bear market was the brutal decline of 2008-2009 during the Global Financial crisis As compared to a buy-and-hold strategy, the rebalanced portfolio once again provided a superior recovery. See Exhibit 4. The rebalanced portfolio also outperformed from the market bottom by 1.78% per year.

Exhibit 4



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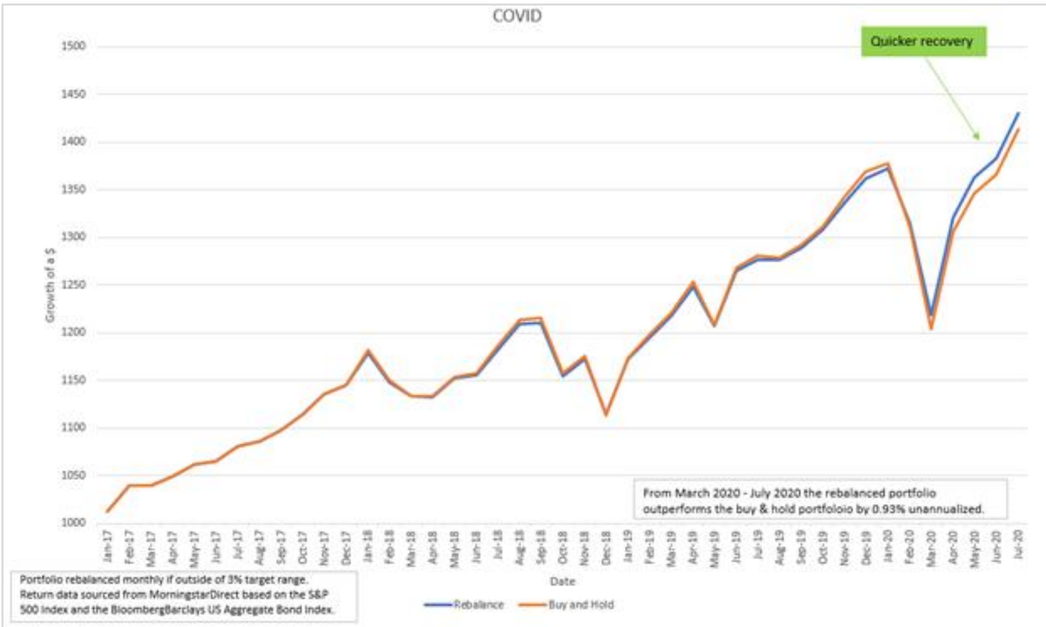
The total benefits of rebalancing surrounding the COVID crisis and bear market will not be available until at least March 2023. However, through July of 2020, it is clear that range-based rebalancing has been very effective. From March through July, the rebalanced portfolio has outperformed a buy-and-hold strategy by 0.93%, as Exhibit 5 indicates.

Exhibit 5



Naturally, rebalancing can easily be implemented by tax-exempt organizations. For taxable investors, the tax implications of rebalancing should be considered. However, an ongoing tax-loss-harvesting program, especially during bear markets, can help offset the taxable gains from rebalancing, potentially to the point of offsetting all realized gains.

Investment Management Process

Nearly every state in the country has adopted a prudent investor rule. Combined with ERISA standards, a code of conduct has emerged as an excellent guide for all investors managing investment portfolios.

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Exhibit 6

Uniform Code of Fiduciary Conduct*

1. *Prepare written investment policies and document the process used derive investment decisions.*
2. *Diversify portfolio assets with regards to the specific risk/return objectives of participants/beneficiaries.*
3. *Use professional money managers ("prudent experts") to make investment decisions.*
4. *Control and account for all investment expenses.*
5. *Monitor the activities of all money managers and service providers.*
6. *Avoid conflicts of interest.*

* *The Management of Investment Decisions*, by Donald B. Trone, William R. Allbright and Philip R. Taylor, McGraw-Hill, 1995.

The process in this uniform code has been the basis for investment management of large pension funds and non-profit organizations. In addition, the principles in this code are to guide the following process when managing an investment portfolio.

Steps in the Investment Management Process

Analyze the Current Situation

A myriad of issues should be reviewed and analyzed to determine the objectives of a portfolio.

The key issues include:

- Timeframe of the Portfolio – The longer the time frame the more the risk that can be taken. The opposite is true as well.
- Downside Risk Tolerance – The best way to determine risk is to identify the amount of a portfolio decline that can be withstood in a 12-month period. While a long timeframe dictates aggressiveness and patience as portfolios to recover, emotional and inexperienced investors usually react in ways that are extremely harmful to returns.
- Return Expectations – Downside risk and return expectations are joined at the hip to help determine the portfolio's appropriate asset allocation.
- Contributions and Distributions – Estimating these factors in advance will help determine a portfolio's aggressiveness. A portfolio in a distribution mode should be more conservative.

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Design the Portfolio

Based on the objectives determined by analyzing the current situation, an asset allocation study should be conducted to determine the appropriate level diversification. Investments may include equity strategies, fixed income, and diversifying strategies, including hedge funds, private equity, real assets, etc. For taxable investors, strategies including municipal bonds should ordinarily be favored over taxable fixed income. We believe that a portfolio's asset allocation should be reviewed at least annually. The expected risk and return characteristics should be updated based on a forward-looking view of the economy and markets, not historical returns.

Exhibit 7

Asset Allocation Study

2020 - Asset Mix Alternatives

Portfolio Component	IPS	Mix 1	Mix 2	Mix 3
Large Cap (U.S.)	18%	16%	18%	20%
Small/Mid Cap (U.S.)	8%	6%	7%	8%
Int'l Equity (Developed)	16%	13%	15%	17%
Emerging Mkt Equity	5%	4%	5%	5%
Domestic Fixed Inc.	8%	14%	8%	3%
Float. Rate Corp Loans	5%	5%	5%	5%
Real Estate	6%	5%	5%	5%
Low Correlated Hedge	15%	18%	18%	18%
Other Real Assets	7%	7%	7%	7%
Private Equity	5%	5%	5%	5%
Illiquid Credit	7%	7%	7%	7%
Totals	100%	100%	100%	100%
Expected Return	6.02%	5.75%	6.00%	6.25%

2020 – Projected Downside Risk in a 12-Month Period

	IPS	Mix 1	Mix 2	Mix 3
95th Percentile	(17%)	(15%)	(16%)	(18%)
99th Percentile	(24%)	(22%)	(24%)	(26%)
Prob > 0.00%	64%	65%	64%	63%

Objective
CPI + 4.25%
(6.50%)

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Document the Process

Summarizing the portfolio's goals, objectives, time horizon, risk tolerance, and strategic asset allocation in a written Investment Policy Statement is a best practice. In addition, outlining the process for manager/strategy selection and monitoring the portfolio is advised.

Implement the Portfolio

Another process is to determine the products and investment managers that should be utilized in the portfolio. Depending on the asset class and benchmark, active managers may struggle to outperform after fees. There are other strategies where active managers can add significant value. Quantitative analysis can help determine the likelihood of an active manager outperforming a passive index fund. We recommend analyzing performance comparisons over short periods of time and especially during bad markets. Look for their rebound consistency. Historical underperformance should be very tolerable if drawdowns in bad markets are more shallow. Other strategies, including hedge fund strategies, private debt and equity, collectables, and real assets, are usually difficult to benchmark.

The qualitative side of due diligence is a crucial component of an investment product review. An investor should answer the following:

- Who manages the portfolio and are they responsible for the track record?
- Is the managing firm's ownership structure a positive or negative? Explain.
- What is the product's strategy, philosophy, and process? Are all risks understood?
- Do the historical performance track record and the strategy relate?
- How has the strategy changed over time?
- Is the track record audited? How was the track record developed?
- Have flows into or out of the product been stable?
- What is the product's client profile?
- How tax efficient is the product? (if used in a taxable portfolio)
- What is the fee structure, and is it reasonable?

Key issues when analyzing investment performance are:

- Why has performance been the way it was in various markets?
- Was performance luck or skill?

For taxable investors low turnover, tax-efficient managers should be utilized, along with tax-loss harvesting strategies throughout each calendar year.

Monitoring the Portfolio

The portfolio should be monitored relative to its goals and objectives, risk and return, as well as relative to the benchmarks based on the portfolio's design. A quality performance report will help an investor understand the "why's" of performance – at the portfolio and manager levels. The report should be a compass for making decisions.

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Conclusion

> *"Process is the key to the approach required of fiduciaries by today's prudence standard. Of course, the purpose of the process standard is to best assure well-reasoned decisions leading to long-term positive investment performance, taking advantage of the best information and practices available."*
>
> - *The Management of Investment Decisions,* by Donald B. Trone, William R. Allbright and Philip R. Taylor, McGraw-Hill, 1995.

The best investors are process oriented and realize that they cannot consistently predict the future. Many investors, on the other hand, are unsuccessful because they often rely too much on predictions and not enough on process. Intellectual humility is in large part why process-oriented investors are successful. Warren Buffett correctly observed: *"Forecasts usually tell us more of the forecaster than of the future."*

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