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Investing in alternatives for a well-diversified portfolio

By Mike Kelly, President & Chief Investment Officer, FS Investments, and Dr. Vinay Nair, Founder & Chairman, 55ip
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Volatility roared back in the first half of 2018, offering a powerful reminder of the impact that swings in the market can have on investors' portfolios. Prolonged market volatility or sharp spikes in volatility can have a significant impact on wealth creation, especially for investors that rely on periodic withdrawals from their portfolios to fund expenses. One obstacle on the path to wealth creation is the risk of extreme losses. Losses are part of any journey, but extreme losses don't have to be. Extreme losses often become permanent losses. The objective of avoiding permanent losses inspired Warren Buffett to say that the first rule of investing is "Never lose money" and the second is "Never forget rule No. 1."[1]

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Any portfolio that seeks to maximize wealth should mitigate the risk of extreme losses. What counts as extreme? One example is when the S&P 500 plummeted 54% between October 2007 and March 2009.[2] Exposure to such losses creates a difficult crossroads for the investor, where neither action nor inaction is the obvious choice. Recovering from such losses takes time. For example, a drop of 50% would require a rally of 100% just to recoup the losses. Investors who faced the above-noted drawdown and stayed put had to wait four years to recover. Extremely sophisticated risk management systems and in-depth research have sought to better understand and address this risk. The most robust takeaway from all this work is rather simple: diversify.

Historically, investors diversified by adding an allocation of bonds to equities to form "balanced" portfolios. The genesis of balanced funds can be traced back to 1928. Against the backdrop of extreme equity losses, Walter Morgan founded the Wellington Fund[3] after observing that bonds did well during times when equities underperformed. In fact, bonds returned over 6% during the 1930s when equities fared poorly. This ushered in an era of institutional diversification by mixing equities and bonds together in portfolios. The idea was that, while bonds may not always provide great returns, they help avoid extreme losses in a portfolio.

But diversification is not just about adding positions. Diversification should eventually mitigate concentration risk, that is, being largely exposed to a single source of risk. If your portfolio is particularly vulnerable to one risk, extreme losses may only be a matter of time. Simply having many positions may not address concentration risk. Studies have shown that portfolios allocated 60% to stocks and 40% to bonds actually have 90%–95% of their volatility, and therefore the likelihood of extreme losses, driven by the allocation to stocks.

The difficulty of effective diversification has downed many a professional portfolio manager and generated a constant stream of portfolio construction lessons for the industry. Those invested in balanced portfolios during the 1960s and 1970s learned one of them when both bonds and equities lost at the same time. Yes, there were periods from 1926–1957 where both bonds and equities lost, but bonds were relatively calm. There were no double-digit drawdowns in long-term U.S. Treasury bonds during this period. But the ’60s and ’70s changed that. During the ’70s, a 60/40 portfolio lost 3% per annum in real terms across the G8 markets,[4] as both stocks and bonds declined. It became clear that investors needed newer sources of diversification.

This created room for what we now call alternatives. In the ’70s and ’80s, wealthy individuals began to invest in private equity, real estate and hedge funds to enhance returns and diversify risk. Institutions, such as Yale University’s endowment, followed, pioneering what became known as the “endowment model” of investing. These alternative funds and their sophisticated investors formed an exclusive club where members could build better portfolios. Nonmembers had to remain satisfied with traditional “balanced” portfolios.

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Since the crisis of 2008, alternative investments have grown in popularity and become accessible to a broader audience, including retail investors. New funds incorporate alternative investment strategies such as private credit, private equity and real estate and are managed by top institutional investment managers through regulated structures that provide access at lower investment minimums than in the past.

As retail investors face the reality that what was once considered a balanced portfolio now presents concentration risk due to rising rates, shrinking liquidity and integrated asset markets, they may be more interested in incorporating alternative approaches. For example, lending to more senior parts of a private company’s capital structure or investing in real estate may help generate income, and funds that do this may provide more stability to a portfolio.

Critics might argue that some alternative approaches, such as hedge funds, have not kept up with the stock market even if they have dampened volatility and drawdowns. It is important to note that when an investor, whether an endowment or an individual, needs to withdraw from their portfolios over time, a dampened lower-volatility stream of returns generates higher future wealth. In other words, steady withdrawals require steady returns if you want to meet planned wealth outcomes.

An investor who must meet a constant stream of spending needs over time will more likely end up with greater wealth if they have a more stable return stream. Such a dampened return stream, by definition, will indeed underperform in up markets and outperform in down markets.

Simulations[5] based on a $1 million investment over 10 years with $10,000 monthly withdrawals show:

- The value of a lower-volatility portfolio (5% volatility) after 10 years is nearly 26% higher compared to the value of a higher-volatility portfolio (15% volatility) after 10 years.
- The lower-volatility portfolio has a less than 1% chance of running out of money before 10 years, while there is almost a 10% chance of this with the higher-volatility portfolio.

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Investors typically rely on alternatives to balance and diversify their portfolios. For many, the question is not whether their portfolios should include alternatives. Rather, the questions are which ones they should include and how much they should allocate to them. The answers should come from an advisor who understands financial planning, the impact of withdrawals on long-term wealth accumulation and the suitability of these investments for their individual investor clients. The key is to identify how funds in the category possibly address the risk of extreme losses while providing rewards for the risks they take.

To be clear, diversification does not eliminate the risk of experiencing investment losses. Further, any investment category, especially one as diverse as alternatives, can never be recommended in its entirety. Alternatives present certain risks that should be considered when adding them to portfolios. They're a bit like medicine prescribed by a doctor, while stocks and bonds are their over-the-counter brethren. In today's environment of very low income and yields, stubbornly low growth and exorbitant stock market valuations, it may be time for prescription medication.

Mike Kelly

President & Chief Investment Officer

As President & Chief Investment Officer of FS Investments, Mike looks to the future of investing trends, constantly exploring new alternative investment strategies. He oversees the firm's investment management, product development, capital markets, due diligence and investment research functions. Mike gives back by serving as a board member of Invest in Others and the Spotlight Foundation, which he co-founded, and previously served as a trustee of the Stanford Graduate School of Business Trust.

1 Mary Buffett and David Clark, *The Tao of Warren Buffett*, 2006.

2 Macrobond.

3 The Wellington Fund was the first balanced mutual fund in the United States.

4 G8 refers to the group of eight highly industrialized nations: France, Germany, Italy, the United Kingdom, Japan, the United States, Canada and Russia.

5 Dr. Vinay Nair and Magnus Sigurdsson, "The Secret to Steady Withdrawals? Steady Returns," 55ip, July 2016. 10,000 simulations were generated (to represent 10,000 hypothetical investors) from 10 years of returns on $1 million that averaged 12% annually (through monthly randomly generated returns) at an annual volatility of 5% vs. 15%. The exercise was then modified to include a fixed monthly withdrawal of $10,000 to generate the 12% return expectation on $1 million.