SFA
Santa Fe Advisors

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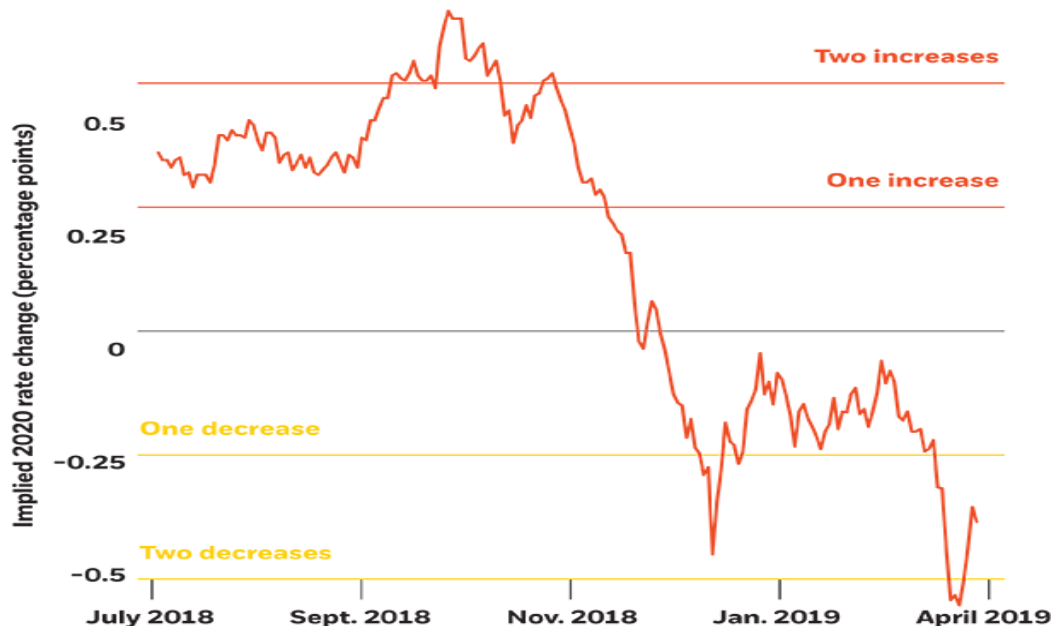
Time as a Risk Dimension

In stark contrast to the jarring price corrections that rocked equity and credit markets in late 2018, the first quarter of 2019 rewarded investors with an equally sharp rebound. After a swift 20% decline ending on Christmas Eve, the S&P 500 returned 13.6% in the first quarter, marking the best start to a year for large US company stocks since 1998. As of this writing, the index has recovered to within 1% of its all-time high. Other risky markets also posted strong first quarter results: REITs benefitted from lower interest rates and returned 17.2%, high yield bonds gained 7.3%, and foreign stocks (both developed and emerging market) returned close to 10%.

The exercise of trying to explain severe market moves like these is one that captures great interest, and consumes tremendous resources – it is also, largely, a futile one, generally yielding no assurance of accuracy or actionable information. While market prices largely correlate to economic fundamentals over time, changes in fundamentals are not always readily apparent. Additionally, human emotion often drives markets, exacerbating short term price swings, both up and down.

The recent volatility is instructive, in that it occurred during a period of few major changes in global macro-economic fundamentals: the global and US economies continued to expand (at a slowing pace), company earnings remained strong, trade risks were balanced by an expectation of a positive resolution, and political risks continued to simmer in Europe. The one clear change has been in markets' perception of future monetary policy both in the US and in Europe: the Fed and the ECB both signaled that policy going forward would be less restrictive (i.e. rate increases would stop or be delayed) than had been anticipated, as a result of slower economic growth. This expectation of easier policy cheered markets, and certainly played a role in 2019's rally. Graph 1 shows how swiftly market expectations of 2020 Fed policy reversed in recent months, moving from the expectation of two rate increases to two decreases.

Graph 1



Source: Blackrock, BBG

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Investment Strategy During Volatile Periods

Although observing the impact of a policy change on markets is often not difficult, predicting such a change (and acting on it in a timely manner) is another matter entirely – in fact, trying to do so is another largely futile exercise. A more realistic strategy (which we pursue at SFA) is to try to react to significant market moves by tactically adding risk after assets become cheap, or to trim risk after assets become expensive. Even implementing this approach can be challenging: for example, we had decided to add portfolio risk in late December after stocks and high yield bond prices dropped to attractive levels, and were about to do so when the market rally began. Markets rose so quickly that we decided to hold off, opting not to buy into higher (and less compelling) prices.

These challenges underscore a theme we often articulate, which is **the *importance of adopting a reasonably low cost investment strategy with portfolio risk aligned with the investor's goals and circumstances, and then sticking with it throughout market cycles***. While it is entirely rational to feel good when markets rally and our wealth increases, and to feel bad when market declines cause losses, it is a grave mistake to adjust investment strategy based on such moves. ***Acting on these impulses often leads investors to cut risk at lower prices, and add risk at higher prices, when the opposite is the correct approach***. Ultimately, markets tend to recover: the US stock market has historically produced positive returns in about 75% of calendar years, underscoring the inadvisability of selling after a downturn with the intent of getting back in when the coast is clear.

The Time Element of Risk

The fact that stock markets generally produce positive returns (and eventually recover from even severe losses) introduces a very important concept about risk, which is the ***time element of risk***. Typically when investment risk is discussed, the primary metric considered is investment volatility, particularly downside volatility or risk of loss. By this measure, stocks are considered quite risky (indeed, we've seen two devastating stock market declines in the last 20 years), and high quality bonds are considered to be low risk. There is logic to this view of risk: for a retiree with a short investment time horizon (5 years or less) who lives off portfolio income and has little ability to replace losses from earnings, a largely stock portfolio might be inappropriately risky. In contrast, a young early-career investor with a long investment horizon can afford to accept more market volatility, while seeking greater returns. While these examples seem obvious to most of us, it may seem that the former is adopting a low risk strategy, while the latter is (rationally) accepting a high risk strategy.

In fact, this is not the case. When we consider time as a risk measure, a largely stock portfolio that is more volatile (and therefore more risky in the short run) can actually be a ***less risky*** portfolio over a longer time frame. This is because stock returns are usually positive, and with a long enough holding period, short-term losses will be recouped as returns revert to long term averages.

Graph 2 shows historic ranges of three US portfolios over various rolling time cohorts: 100% stocks, 100% High Grade bonds, and 50% stocks/50% bonds.

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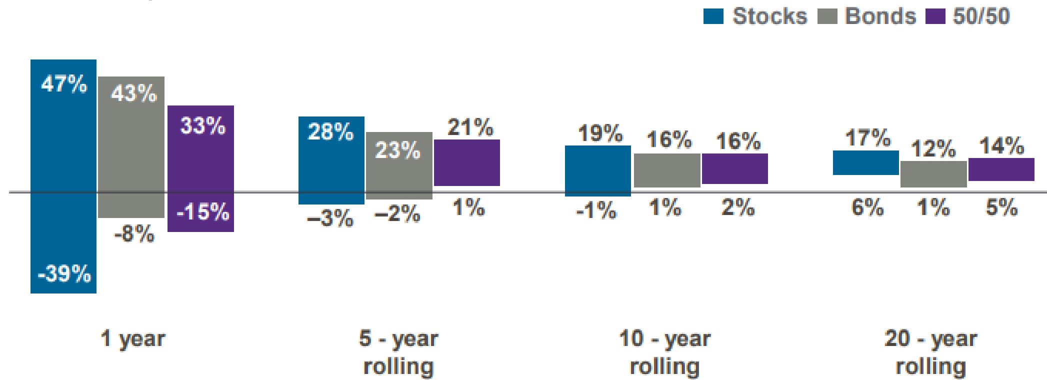
Graph 2



Source: JPM, Barclays, BBG, Factset, FRB, Shiller, Strategas/Ibbotson

Unsurprisingly, over very short time horizons (1 year in this case), the "riskier" all-stock portfolio is in fact much riskier: investors in this portfolio experienced a -39% return in the worst year, an outcome far worse than the -8% worst year for all-bond investors. However, as we observe return ranges over longer time frames, the picture quickly changes. In fact, all three portfolios' downside risk appears similar over 5-10 year periods, and the 100% stock portfolio actually has demonstrated ***less downside*** over 20 year time frames.

This makes clear that time frame, even more than short-term asset volatility, is an absolutely critical dimension of investment risk. Indeed, a long holding period greatly reduces the risk of "risky" assets such as stocks (as price rises recoup losses), and increases the risk of "low-risk" assets such as high grade bonds (as lower returns outweigh volatility benefits).

This brief overview of the impact of time frame as a risk measure heavily influences our investment strategy, and our thinking when we advise clients to choose and stick with an appropriate level of risk, making strategic changes only in the event of changes in personal circumstances, and not because of news headlines or recent market moves.

Thank you for your trust, which we work hard to earn every day. If you have any questions, please contact any member of the SFA team.

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