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Auld Lang Syne: 3 New Year's Resolutions for Investors

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Be at war with your vices, at peace with your neighbors, and let every New Year find you a better man.

— Benjamin Franklin

It's been an outstanding year for investors. Almost regardless of the investment choice — stocks, bonds, real estate or private equity — returns have been solid. A decade of easy global monetary policy has fueled the market to barrel down the tracks like the Polar Express. With Christmas coming, the goose is getting fat — and so are investors' wallets. And the nearly nine-year-long bull market is leaping like the 10 Lords, closer to hitting all-time records for both length and depth.

Their cups running over with holiday cheer, investors will welcome the New Year with bloated accounts. Nobody's complaining about that. But many of us, after binging on great food and tasty drinks from Thanksgiving to New Year's, will also find that our clothes fit more snugly and our minds are lethargic. As I'm writing, it's not even Christmas, and my suit pants already are squeezing me uncomfortably while my mind drifts off to a warm weather holiday with my family over the winter school break. And so, as we do every year as the wistful notes of *"Auld Lang Syne"* and the magic of the holiday season recede, we'll have the opportunity to reflect on the year that has passed and make resolutions to improve in the future.

Should Old Resolutions Be Forgot, and Never Brought to Mind?

Not surprisingly, googling the most popular New Year's resolutions from the recent past reveals a consistent top three list:

1. Exercise more
2. Lose weight
3. Eat healthy

Can we achieve all three? Fat chance! Pun intended. Experience tells us that no matter how well intentioned our goals, human behavior is difficult to change — and it rarely changes quickly. Simply, it's naive to expect change just because we are flipping the calendar from one year to the next. Sure, we'll start out strong. That's why it's next to impossible to get on the exercise equipment at the gym or find a spot in that goat yoga class in early January. But by the time Groundhog Day rolls around, there is plenty of room to work out at the gym or stretch with the goats.

Similar challenges arise when it comes to changing investor behavior, especially in the short term. However, if you apply the top 3 New Year's resolutions to your portfolios, at least when it comes to your investments, you can exercise more, lose weight and eat healthy.

1. Exercise More: Take an Active Approach to Investing and Feel the Burn

Much has been made about the sizeable sums leaving active investment management. In fact, I covered the topic in some length in last month's Uncommon Sense. A good portion of those outflows have found their way into index funds, so-called passive investing. Thus far in 2017, investors have added $26B into active funds and $637B into passive funds.[1] Purchasing a fund that mimics the index at the lowest possible cost has been a winning formula for investors

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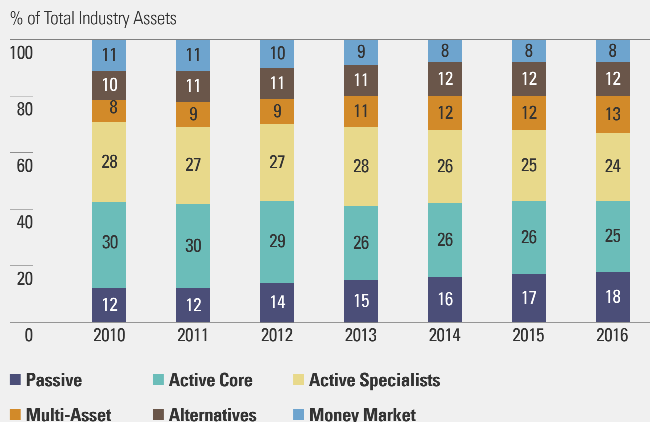
throughout this long bull market. The uninterrupted climb to record highs for many global stock market benchmarks has led investors to rely on a set-it-and-forget-it approach to investing. And, why not? The S&P 500 Index hasn't experienced a decline of 3% or more all year. To put that in historical context, the current 400+ day stretch without a decline of 3% or more is the longest ever.[2]

Overwhelming evidence suggests that index investing is often the best choice for investors for many parts of their portfolios.[3] However, given the length of both the economic expansion and bull market, it's no time for investors to become *passive* when it comes to managing their investment portfolios. So, put down that eggnog, get off the couch and resolve to exercise your portfolios in the following 3 ways:

Figure 1: While Passive Is Growing Its Share, a Range of Investment Strategies Remain



Source: McKinsey: Bright Spots in the North American Asset Management Landscape, December 2017.

- **Revisit your asset allocation mix**. The New Year is as good a time as any to evaluate how much of your portfolio is in stocks, bonds and alternative investments and make adjustments, if necessary, to better fit today's environment. Certainly, synchronized global economic growth supported by improving corporate profits, still easy monetary policy, low rates, benign inflation, less stringent regulation and the potential for lower taxes provides an attractive backdrop for stocks in 2018. So overweighting equities may make sense for investors.

  On the other hand, the yields that bond investors are receiving for the interest and credit risks they are taking continue to be skewed to the downside. As a result, many investors remain underweight to bonds. However, bonds play an important role in diversified portfolios from capital preservation and income generation to diversification. So, despite the risks, some allocation to bonds makes sense for most investors.

  With many financial assets at record highs and most measures of financial volatility at all-time lows, it's also a good time to revisit portfolio allocations to alternative investments that may be more likely to protect their portfolios in the event of a market crash. Inquiries for protection strategies, especially from our institutional clients, have skyrocketed in 2017. And in an investment landscape awash with expensive choices, many of these long volatility protection strategies are inexpensive. Investors may want to explore the pros and cons of increasing allocations to cash, long maturity US Treasuries, low volatility equity strategies, costless options positions, managed futures, global macro or gold.

- **Actively allocate to asset classes.** Once investors have allocated to stocks, bonds and alternatives, selecting the best choices within these asset classes is another way to get moving in 2018. For example, faster growth, higher profits, easier monetary policy and more attractive relative valuations have led many investors to overweight international developed and emerging market stocks versus US stocks. Decisions also can be made to tilt toward growth or value, small cap versus large cap or specific sectors.

  In the bond market, investors also have many decisions to make. Among their choices are investment grade versus junk bonds; shorter or longer maturities; fixed versus floating rates or sovereign debt or corporates. In today's environment, investors may want to move up in quality, shorten their maturities and invest in more floating rate bonds.

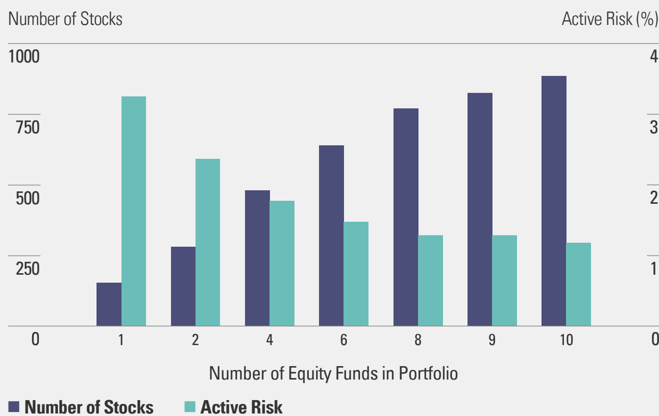
- **Use active investment strategies selectively.** For the core of a fixed income allocation, the index now offers a poor risk/return profile, so using an active management strategy may be beneficial. Given that the most profligate borrowers make up the largest allocations in bond benchmarks, an active manager can often provide a better total return with a lower overall risk profile and offer exposure to all of the sectors of the bond market. Investors also have turned to bank loans to maintain credit exposure and healthy yields, move up the capital structure and gain access to floating rates. At this stage of the credit cycle, an active manager may be better able to navigate the inevitable loan mines in this asset class. Toys R Us provides us a great recent example of why holding an index portfolio of bank loans is risky in the current environment.[4]

2. Lose Weight: Shed Those Excess Investments and Embrace Moderation

Modern Portfolio Theory (MPT) extols the virtues of diversification, leading many investors to claim that diversification is the only "free lunch" in investing. But like all things in life — especially eating — too much is never a good thing. Because investors struggle with how much to diversify, portfolios have become fat — and I don't mean just from rising asset values. Many investors own hundreds, if not thousands of positions in their portfolios. This over-diversification is unnecessary — and costly. It results in uncompensated complexity, high fees and suboptimal investor portfolios.

Many dynamics drive this bloating of portfolios, among them the fear of missing out on a good thing. Investors should stop the madness. It's time to lose the deadweight in overly diversified portfolios. Instead of owning an expensive market portfolio, purchase fewer assets and use more indexing where it makes most sense. This will result in a cheaper, more efficient market portfolio.

Figure 2: The More Stocks You Hold, the More You May Resemble Your Benchmark



Source: Shawn McKay, CFA, Robert Shapiro, CFA and Ric Thomas, CFA, "What Free Lunch? The Costs of Overdiversification." State Street Global Advisors

Where should an investor begin to trim the fat? The disposition effect, an anomaly discovered in behavioral finance, claims that investors sell their winners too quickly while holding on to their losers for much too long. While investors feel good taking a profit, they feel the pain from taking a loss twice as much. I suggest that investors overcome their reluctance to sell losers in their portfolios at a loss and begin to trim poor performing investments from their portfolios. Notably, many experienced traders abide by the rule of thumb, "Your first loss is your best loss."

Additionally, performance analysis at the portfolio level often illustrates that investor positions cancel one another out or sometimes double-up on risk. For example, the growth strategy and the value strategy each might have a large position in the same stock (i.e., Apple). Or perhaps one active international manager is overweight Japan while the other is underweight. Investor portfolios also often have some recognizable biases in them. They have a small cap, value bias with a tilt toward higher-quality investments. Maybe they have some momentum too. A good portion of these attributes can easily and more cheaply be replicated using smart beta factors such as small, value, quality and momentum. Therefore, focusing on these characteristics may be a more efficient, affordable way to construct a global equity portfolio. Once the portfolio is simplified, investors have more time to search for truly different, uncorrelated investment strategies. This may enable them to better achieve specific objectives like growth, income or managing risk.

Of course, diversification remains a way for fiduciaries to manage business risk, litigation risk and investment risk. But diversification can create challenges for portfolios when fiduciaries diversify across a set of diversified investments, as opposed to diversifying across a set of securities with idiosyncratic risk. Finding the right balance between enough and too much diversification is a crucial responsibility for overseeing portfolios.

3. Eat Healthy: Seek Free Cash Flow, the Greens Companies Need to Boost Their Health

Everyone knows more greens are the key to healthy eating. In investing, those greens come from sustainable increases in free cash flows. Cash in the bank is what every company strives to achieve. Investors are interested in what cash a company has in its bank accounts, as these numbers convey the truth about a company's performance. It is more difficult to hide financial misdeeds and management adjustments in the cash flow statement, the measure of cash into and out of a company's bank accounts. Free cash flow, a subset of cash flow, is the amount of cash left over after the company has paid all of its expenses and subtracted what was spent for capital expenditures reinvested in the company. A company can use excess cash, its greens, to distribute dividends, pay off debt, buy back stock and/or expand the business.

Growing free cash flows often indicates sustainable or growing profits — greens that make portfolios healthier. Alternatively, negative or decreasing free cash flows could mean that a company lacks adequate cash to support its operational growth. Without these sustainable healthy greens, these businesses, and ultimately their stocks, fizzle. Empirical evidence suggests that investors that devour investments with sustainable increasing free cash flows are likely to have better performing portfolios. It's always important to identify investments with this characteristic,

but given the length of this economic expansion and bull market, identifying healthy greens/cash flows is perhaps more important than ever.

Figure 3: Higher Free Cash Flow Yield May Lead to Better Performance

Quintiles 1–5 are hypothetical portfolios. The quintiles are drawn from the S&P 500 universe based on free cash flow yield.

Source: S&P Dow Jones Indices, LLC, FactSet. Data from December 1990 to June 2017. Past performance is no guarantee of furure results. Chart provided is for illustrative purposes.

In the S&P 500 Index, health care and technology are currently the second- and third-ranked sectors for generating free cash flow yields. The financial sector is first, but free cash flow can be a less useful measure for banks and insurance companies.[5]

The New Year is Yours, What Will You Do with It?

"Auld Lang Syne" reminds us to remember and cherish old friends and good times and to toast health and goodwill for the year ahead. 2017 was a good year. But there are no shortages of great investors in a bull market. After 8 plus good years for financial assets and unprecedented market calmness in the last 12 months, it's time to guard against complacency and actively engage with your investments. The days of simply buying the index and collecting the profits are most likely past. The easy money has already been made. So, let's resolve to exercise our investment brains, lose the unnecessary weight in our portfolios and scarf down plenty of free cash flow greens in 2018.

On a personal note, I'm incredibly thankful to you, dear reader. Uncommon Sense readership is growing because of folks like you. If you like Uncommon Sense, please spread the word. Thank you for letting me do something that I absolutely love each month and take up some of your reading space. I'm feeling humble, grateful and lucky this holiday season. Happy Holidays and Happy New Year!

[1] Morningstar as of 11/30/2017.

[2] Shawn McKay, CFA, Robert Shapiro, CFA and Ric Thomas, CFA, "What Free Lunch? The Costs of Overdiversification." State Street Global Advisors.

[3] *Morningstar's Active/Passive Barometer Report*, Morningstar. April, 2016 and *SPIVA® U.S. Scorecard,* S&P Dow Jones Indices LLC. Year-end 2016.

[4] Lillian Rizzo and Soma Biswas, "Creditors Put Toys 'R' Us Debt Under Microscope." *The Wall Street Jopurnal*, December 7, 2017.

[5] Blomberg Finance L.P., 12/18/2017.

Glossary

Active Management A portfolio management approach that uses a human hand, such as a single manager, co-managers or a team of managers, to select, adjust and change a fund's holdings over time. The use of a human element, such as a single manager, co-managers or a team of managers, to actively manage a fund's portfolio.

Passive Management An investment strategy that removes the active human hand from the process and replaces it with systematic, rules-based approaches to securities selection. Passive investing, notably index investing, is relatively cheap because it typically limits portfolio turnover and because the passive investing does not involve relatively costly research.

S&P 500 Index A popular benchmark for U.S. large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

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