Keel Point

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## Launching KP's Core Portfolio Strategies

Warren Buffett's letter to Berkshire Hathaway shareholders, released at the end of February, reiterates the oracle's somewhat famous investment advice. For those unfamiliar, it is not a sales pitch for Berkshire shares. Rather, his "regular recommendation has been a low-cost S&P 500 index fund." He reasons that the average market investor earns the overall market return, but is worse off by the amount of fees paid, and therefore should select the least expensive market tracking index fund to maximize their take-home returns.

We have a different take. The low-cost index fund idea is sound as a starting point, but insufficient to lead to financial success for many clients. And the selection of the S&P 500, while earning points for simplicity and identifiability, does not evade the reality that it, like any market index, is a product of arbitrary rules. Per Vanguard there are over 3,500 public companies in the US; the 500 in the S&P represent 80% of that universe by value. Cutting your options at 500 categorically ignores 3,000 or more companies representing one fifth of the market. Buffett's cut also ignores over 5,000 public companies outside of the US.

More importantly, an S&P-only portfolio lacks risk management. For many clients, full market risk is inappropriate. Shorter-term spending needs or an honest assessment that the equity rollercoaster is too much to stomach leads to a desire for less than full market risk. Keel Point believes solving for a portfolio that must not experience the full ride is an area in which we differentiate; the solution set isn't as simple as a single or handful of unchanging index fund(s).

This philosophy forms the bedrock of our recently launched suite of portfolios (Core Portfolio Strategies, or "CPS"). These are grounded in the same risk management process we use for all of our portfolios, one that targets risk at one of four levels: aggressive (commensurate with the risk you would expect from a portfolio of 90% global stocks and 10% U.S. bonds), growth (75%/25%), intermediate (55%/45%), and conservative (35%/65%). Whereas our existing models are not constrained by product type, CPS will only use low-cost index and exchange traded funds ("ETFs") to fill the asset class weights determined by the risk targeting model.

These asset classes are broader than the 500 companies in the S&P. Specifically, we think we can improve results for CPS clients, by including an allocation to:

1. *US smaller companies* (the other 20% of the domestic stock market). A long history of academic research suggests smaller US stocks outperform their larger brethren, albeit with more return volatility.
2. *Non-US stocks* (the other 5,000 stocks). While these have not outperformed the US recently, they have in 44% of three year periods going back to the early 1970s (see the June 2016 *Investment Bulletin* on our website for more information). This provides an opportunity to add value via tilting between the US and international asset classes.
3. *Bonds*. We primarily use these to manage risk. And we intend to be opportunistic. Right now, for instance, we have an allocation to high yield bonds in the category. We believe the extra yield is likely to flow to the bottom line – economic conditions are currently favorable for limited defaults.
4. *Alternatives*. Real estate investment trusts (REITs) and energy infrastructure master limited partnerships (MLPs) are non-traditional assets that have the potential to deliver risk-adjusted returns competitive with equity.

The portfolio allocations above represent the first step in a dynamic process. Within CPS we will express decisions about levels of interest rate risk, US versus non-US tilts, rotation in the alternatives sleeve, and all other large macro views set by the Investment Team. While the expression of our view may take a different format (e.g. using an ETF rather than an active manager to reflect a small company tilt), the thrust of our ongoing management will be consistent across CPS and our existing portfolio models.

In our view there is utility in the simplicity of this approach. Portfolio results should track closely with the appropriate blend of the global stock and US bond indices. And costs are significantly reduced. Blended ETF fees for the current portfolio are down to 0.15% to 0.17%, exclusive of Keel Point's management fee, depending on the risk level.

### ***The ETF is not a panacea***

To round out our discussion we have two thoughts on what CPS is not. Our design process was not an effort to take everything in our existing models and replace with an ETF. Certain alternative strategies, especially equity diversifiers like reinsurance and hedging strategies (see this month's companion piece for one such strategy), are poor candidates for the ETF structure. Even if an ETF exists in some of these cases, we don't think investors get the portfolio impact we're counting on from the active managers we use. CPS therefore does not have exposure to these conservative alternatives. Our risk targeting process has taken this into consideration and adjusted elsewhere, most notably by increasing the bond allocation.

Second, CPS is not a no-confidence vote in active managers. We use active management in existing models and believe it can add value in certain asset classes. For example, we agree with Buffett that it is hard to generate alpha in a portfolio of US large companies, but do believe there are opportunities for bond managers to pick up some return by timing interest rate risk. Active managers will usually lead to wider portfolio separation from the risk-level benchmark. This means there is an opportunity to outperform but also the opportunity to trail. CPS shrinks the likely breadth of divergence, thus offering a way to improve the predictability of returns relative to a benchmark yet still benefit from Keel Point's multi-asset class, risk-managed process. □

## Explaining Managed Futures

Investors continue to find themselves with weakened options to diversify market risk. The stalwart ten-year government bond, a buttress against equity market selloffs over the last 35 years, currently rewards investors with just 2.6% per year, fully taxable. Gold goes in and out of favor. CDs currently do not pay enough to make up for inflation's steady erosion of purchasing power.

Trend following, a favorite strategy of managed futures funds, represents a different approach to portfolio diversification. Trend followers believe markets are not random; rather they often trend in one direction or the other. They posit that, on average, you can determine a signal or multiple signals that indicate the market trend, and put on an appropriate long or short position to profit. This agility is particularly valuable in downward trending markets: their capacity to short means there is potential to make money in these environments. Trend following thus presents as a useful strategy to diversify market risk.

Let's examine the trend follower's thesis. Do we believe trends actually develop, and if so, persist for long enough to generate trading profits on average? Has the managed futures space delivered on this concept? If we believe the answers here are yes, then what do we make of their characteristics over the shorter time periods that test investors' discipline to stick with a strategy?

Before we go on, and for the sake of completeness, we should note a few more points. Trend following is often the dominant portion of a managed futures fund, but not always, and often not the only strategy. Second, we present a relatively simple explanation of the strategy here, but there is often much more to the story – certainly the algorithms they use to make investment decisions are much more sophisticated. And last, most managers trade in a highly diversified set of assets: broad stock indices, interest rate contracts, commodity and currency futures, etc. We focus on their relationship to equity, but it is important to know that trends developing in other areas will have a meaningful impact on results over the long-term.

***Do Trends Develop and, if so, Persist?***

If a market efficiently prices assets then you would not expect significant price trends to develop. This is the statement of an efficient market disciple. But it is not hard to push back against the notion of perfect efficiency. Most people would say that tech stocks priced irrationally in the run-up to Y2K. Two significant trends formed as result: up in the late '90s and down in the early '00s. Further, you must suspend disbelief to call mid-'00s mortgage bonds efficiently priced. The result: another set of trends.

Two major events do not prove a strategy profitable, however. One way to think more comprehensively about the profitability of trend following is to test a simple rule. Let's define an uptrend as any trailing twelve-month period showing a positive S&P 500 total (meaning inclusive of dividends) return. A downtrend will be any twelve-month period showing a negative total return. This simple strategy buys the S&P 500 whenever we observe an uptrend and sits out (earning the prevailing return on cash) after an observed downtrend. The strategy makes the up or downtrend evaluation at the end of every month and changes the investment if the trend flips.

Since 1929 such a strategy would have returned 9.1% compared to 9.0% for the investor who simply owned the S&P 500. Further, the trend following rule delivers this performance with one-third less risk (13.0% standard deviation of returns vs. 18.9%). This should not be possible in a perfectly efficient market, therefore, it is reasonable to conclude trends do form and can persist at lengths that allow for profitable trading strategies.

***What Does the Record Say?***

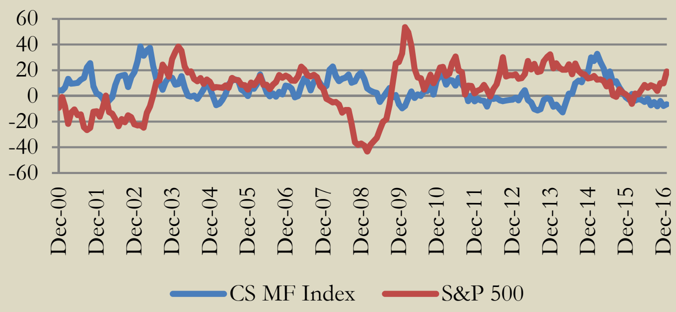
A managed futures strategy takes this simplified logic and expands to other asset classes, adds the ability to go short, and increases the sophistication of trend identification. Proxied with the Credit Suisse Managed Futures index (the benchmark we use on our performance reports) the strategy annualizes at a 4.5% return over the period from 2000 to January 2017. This compares to 4.6% for the S&P 500; 5.2% for the Barclays Aggregate (you could think of this as an alternative way to hedge a portfolio, albeit one flattered by a favorable interest rate environment over the period); and 4.5% for a MSCI All Country World Index/Barclays Aggregate Bond Index blend with equivalent risk (the typical way we make apples to apples comparisons of investment strategies).

***And Over Shorter Windows?***

Multi-decade averages can obscure strength and weakness in shorter periods. Figure 1 shows how managed futures and stocks (S&P 500) have performed over one year periods. It serves as a good illustration of the former's ability to hedge the latter's forgettable years.

Crashes in 2000-02 and 2007-08 coincided with strong positive returns from managed futures. A similar graph showing the Barclays Aggregate would generally show positive returns coinciding with equity losses, but not at the same magnitude.

**Figure 1: Rolling 12 Month Returns (%)**
Managed Futures vs. Stocks
*Source: Bloomberg*




However, there are long periods, certainly recently, of low returns. This is evident on the graph in the years after the financial crisis. Table 1 summarizes these observations by categorizing managed futures' results by market environment. Strong equity markets are not often fertile ground – managed futures earns just 5.4% on average when the S&P earns at least 10%. Further, they are positive just 67% of the time. Conversely, they deliver their best performance (+12.2% on average, positive 90% of the time) when the S&P loses more than 10%. In years when the S&P grows, but not more than 10%, managed futures earns 0.5% and when the S&P is down, but not more than 10%, managed futures delivered 9.6%. The performance by market environment is indicative of a quality portfolio hedge – on average it does not cost money in the good years (like, say, a portfolio insuring put option would) and delivers meaningful results in the bad ones.

**Table 1: Managed Futures by Market State**
Rolling 12 Month Periods ending Dec 2000 to Jan 2017
*Source: Bloomberg*

| | Frequency | Avg S&P 500 Return | Avg CS Mgd Fut Return | % CS Mgd Fut Positive |
|---|---|---|---|---|
| S&P > 10% | 48% | 19.6% | 5.4% | 67% |
| S&P 0 to 10% | 24% | 6.1% | 0.5% | 43% |
| S&P -10% to 0% | 8% | -4.8% | 9.6% | 80% |
| S&P < -10% | 20% | -21.9% | 12.2% | 90% |

### *A Portfolio Context*

We think about these strategies as a building block for portfolios and are therefore most interested in how they interact with the other blocks. Most portfolios have exposure to the four major categories traded by trend followers. Equity and interest rate (bonds) risk are usually a given, but currency (e.g. non-US equity or bond investments unhedged to the dollar) and commodity (e.g. energy and materials companies) risk play a role in portfolio results as well. Managed futures strategies take long or short positions in each of the categories. You might think of them as a trend-based approach to tweaking exposure to each asset class. For example, the strategy might add to your international equity risk in an equity uptrend, but hedge out some of your currency risk in a currency downtrend. The sum of the interaction is generally to reduce overall portfolio volatility, as measured by standard deviation of returns and drawdown, without sacrificing return over the long-term.

Quickly returning to the graph and table we can reach another conclusion – managed futures strategies need drawdowns to differentiate themselves. Their historic ability to avoid or go short in the selloffs has made up for underperformance in positive markets. Future drawdowns are likely, but not easily predicted. We think a managed futures allocation, with helpful properties in market stress and competitive long-run returns, deserves consideration for the drawdown mitigation toolkit. □