Thought leadership: Building portfolios for market crises

How do advisers and their clients achieve true diversification, or investments that will perform and protect in an equity market crisis? **Darren Snyder** writes.

Earlier this month Financial Standard hosted its latest roundtable event, turning attention to how fund managers, financial advisers, researchers and analysts build investment portfolios for market crises.

In attendance were Angela Ashton, director at Evergreen Consultants; Edward Blight, partner at Crestone Wealth Management; Robert da Silva, head of research at SQM Research; John Dyall, head of investment research at Rainmaker; Chris Forrest senior partner and principal adviser at Sovereign Wealth Partners; Miriam Herold, head of managed fund research at IOOF; and Brendan Irwin, head of research at Centrepoint Alliance.

Also in attendance were Philippe Jordan, president at CFM; Kunal Kotwal, senior analyst at Morningstar Australasia; Henry Mortlock, associate at PlayfairTan; Stephen Robertson, founding partner and managing director at Winston Capital Partners; Steve Shepherd, head of Asia Pacific at CFM; Matthew Walker, director at WLM Financial Services; John Wong, senior analyst at AMP; Mark Yetman, director of Australia at CFM.

The key question posed to each attendee was how do we convince financial advisers to "stay the course" when the markets' are going up and down?

The starting point

Winston Capital Partners founding partner and managing director Stephen Robertson says market crises are a concern held by all his clients.

"We really haven't had big market crises – in terms of a big drawdown, particularly in domestic equities – for nearly 10 years," he says.

"The biggest drawdown I could see since the big one 10 years ago was the 12 months to February 2016, when the Aussie market was down about 15% from peak to trough.

"During that time we've seen bonds rally and building portfolios in this market environment is a challenge to us all."

For advisers to "stay the course", WLM Financial Services director Matthew Walker says it comes down to individual investment philosophies and where advised clients are starting from.

"If you are benchmarking investments against the market then you're going to have that conversation with clients about what you're doing relative to the market," Walker says.

At WLM he has taken a different approach. Walker introduced a goals-based investment solution for retail clients – and there's never been a discussion about markets.

"We talk about them [clients], their goals and what they want. Therefore this discussion has not come up in years. What the market is doing has no relevance to what they do," he says.

However this is not representative of every advised client.

SQM Research head of research Robert da Silva says behavioural insights over the past decade show people do not always act rationally in times of market crises and make decisions which "are not necessarily in their best interests."

His point being that while staying the course might be in someone's best interests, the challenge is to educate them and convert them to go against natural instinct – which is to react to everything.

The quote

When you focus on the individual performance of a single investment it means you lose sight of what the portfolio's role is.

Morningstar Australasia senior analyst Kunal Kotwal says investor reaction times to market crises are critical to returns and the wrong choice made – based around not fully understanding the investment product – creates "investor gaps."

"We've got this concept called the investor gap. This is the difference between time-weighted returns and dollar-weighted returns, and if the gap is very big, essentially investors aren't completely realising returns," Kotwal said.

AMP senior analyst John Wong says the most prevalent challenge about "staying the course" is educating clients to focus on the total portfolio outcome.

"When you focus on the individual performance of a single investment it means you lose sight of what the portfolio's role is and how it is incorporated to deliver the goals or objectives," he says.

Sovereign Wealth Partners senior partner and principal adviser Chris Forrest says at the coalface it is up to advisers to educate

and garner client trust. To do this they must have evidence that investment products justify portfolio inclusion.

Investment with purpose

IOOF head managed fund research Miriam Herold says when talking to financial planners about staying the course it's really about getting them and their client to focus on what the purpose of a particular fund is in a portfolio.

"You don't try and [automatically] compare it to global equities that might return 30% in a year," she says.

Herold adds the conversation should be directed around what purpose a particular style of fund holds in a portfolio, and then address what characteristics the adviser or client want from that fund.

To build portfolios for market crises, Forrest said he would look to alternatives strategies because generally they are uncorrelated to traditional asset classes.

"Whilst [these strategies] doesn't give us positive figures all the time, we're looking to reduce the volatility in a portfolio at all times because we can't predict when crises will come," Forrest says.

Staying the course is a challenge – but with the absence of perfect foresight – then Forrest sees a valuable position for funds in managed futures strategies within his investment portfolios.

What is the right strategy?

Capital Fund Management (CFM) president Philippe Jordan says true-to-label balanced portfolios have been rare since the Global Financial Crisis. He says the disappearance means investors have become over-reliant on equity returns, which have undoubtedly been great.

"Owning equities at a cheap price point in the form of beta in decent markets is a decent strategy over the long haul, if you can condition them not to be timed to the market – and that's a big if," he says.

Evergreen Consultants director Angela Ashton says when it comes to addressing retirement income portfolios, for example, a straight balanced fund is less than ideal because of sequencing risk.

"Ideally you'd like balanced returns but with lower volatility," she says.

Crestone Wealth Management partner Edward Blight says his investor base, purely wholesale and high-net-worth clients, aren't interested in retirement income but total return – and alternatives are a good way to package this requirement.

He says there have been comparisons of managed futures or crisis alpha strategies to being long volatility – and there are some long volatility strategies proliferating in the market. He asks: Why would you use managed futures rather than long volatility in a diversified strategy if you're looking for crisis alpha?

Centrepoint Alliance head of research Brendan Irwin says in the alternatives space, products such as managed futures strategies are designed to do well in times of crises, which usually happens every five or seven years.

"So getting advisers to stay the course when some of these funds aren't performing well against some of the traditional asset classes is probably one of the big challenges," he says.

SQM's da Silva says that overall, managed futures strategies have turned into a low-return business in the last five years. As it stands the current performance is "not much better than cash rates." Increased volatility over this time was one explanation, he said.

Staying the course

CFM's Jordan says staying the course and building portfolios for market crises is about managing expectations, whether it is adviser or client. He adds there have been 430 market crises in the past 50 years.

The CFM IS Trends Trust, Jordan explains, uses long-term trend following as a strategy. The concept itself is not new and it forms the basis of many managed future and CTA strategies available in Australia and globally.

The quote

The proposition of long-term trend following is not to hedge your equity portfolio, it is to diversify.

"The proposition of long-term trend following is not to hedge your equity portfolio, it is to diversify. That's a nuance that's very important," Jordan says.

"It's not anti-correlated as an equity portfolio but de-correlated.

"What will happen over the course of a protracted bear market – meaning it's in place for six or nine months, or up to two years – statistically it is going to go short in these kinds of events.

"When they do go short they'll provide some tracking to equities but away from that feature you can also make money from long-term trend following from trends that have developed in currencies regardless of what's going on in the stock market.

AMP's Wong says in some ways managed futures have been a victim of their own success, but also in the way messaging has been delivered.

"It can be about crisis alpha and all that kind of stuff but what it boils down to is that managed futures is a trading program," he says.

"Communication should be around what type of position you have been put on and in what type of market conditions, and how it will respond when the market changes. That's a much more correct expectation."

CFM's Jordan says if people develop the expectation that long-term trend following should be up on a delta of one for 80% or 90% of every time the stock market goes down more than 8%, "your clients are going to be disappointed. It's not going to do that."

Jordan explains the expectation should be, over a cycle of 36 months to five years, the correlation of long-term trend following to a long-only equities portfolio should be between zero and 30%.

"That's achieving diversification and that's valuable," he says. **FS**

In association with