ACG Insights: Client Concerns in an Uncertain Market

Introduction

Each year is always very different, but the last year brought with it a unique set of questions for market participants. After a tumultuous end to 2018, and a quick bounce back to begin 2019, we thought it would be helpful to share what we find to be the most common questions we are receiving across our client base.

We have summarized some common questions we received from our clients in this piece by grouping our responses into sections covering equities, fixed income, alternatives and inflation;

Equities

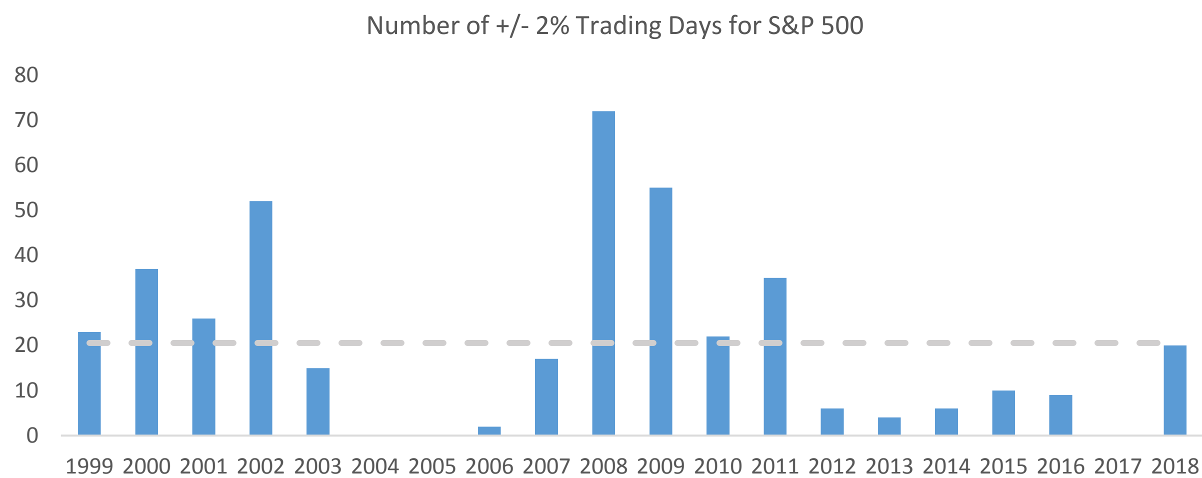
1. ***With a recession potentially looming, should we be holding equities in our portfolio?***

   Atlanta Consulting Group's investment philosophy believes that diversification across asset classes may reduce portfolio volatility and help provide attractive risk-adjusted return compared to a non-diversified portfolio. By combining a variety of different asset classes and styles, which have a low correlation to one other, our goal is to construct a portfolio with the ability to achieve the individual clients' goals and objectives across varying market environments – including recessionary and non-recessionary periods. Atlanta Consulting Group advocates for strategic, long-term investment decisions and does not promote market timing.

   As mentioned in our Fourth Quarter 2018 market commentary, while the risk of a recession is on the rise, most predictive models place a recession during 2019 at around 20% with the risk roughly doubling in 2020 and 2021. Furthermore, fundamentals surrounding economic activity are still positive as job markets remain strong and consumer balance sheets are in better shape compared to their status prior to the financial crisis.

With that said, the S&P 500 has historically had strong returns in the time periods leading up to when a recession actually begins. The average one-year return ending six months prior to when the recession actually begins is +11.9%.

Additionally, while volatility has increased as displayed in the exhibit below, current levels are more in line with longer term historical norms. Consensus view is that increased volatility compared to the past few years is likely to persist. Active managers should benefit from the reemergence of volatility through stock selection and sector rotation.



2. ***With the U.S. markets outperforming international markets and the prospect of a trade war, do we still need international and/or emerging markets exposure?***

Atlanta Consulting Group's core investment philosophy is based on the time-tested idea of diversification. As history has repeatedly affirmed, broad diversification across asset classes, investment styles, geographies and strategies helps to reduce portfolio volatility and can provide superior risk-adjusted returns over a market cycle.

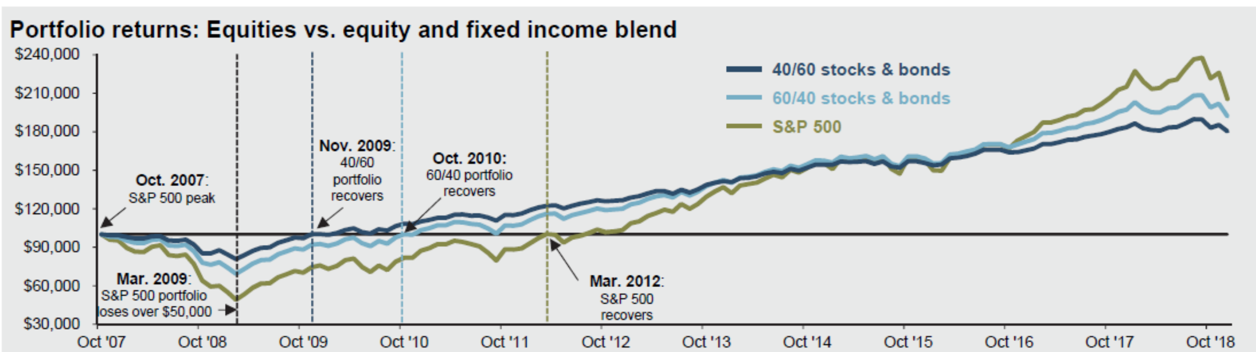
With that said, the last decade has been one of the worst periods on record for diversified portfolios because we have experienced a bull market since the financial crisis, with little volatility. Holding anything other than U.S. large capitalization stocks has detracted from returns. Inevitably this bull market will be followed by a bear market although the timing and severity are hard to predict. When evaluated over a full market cycle, we firmly believe that, similar to other long-term periods, diversification will once again prove to be a superior method of asset allocation.

	Trailing 10 Years			Trailing 20 Years		
	Return	Volatility	Sharpe	Return	Volatility	Sharpe
S&P 500 TR USD	13.12	13.60	0.95	5.62	14.47	0.32
60% S&P 500 40% BC US Agg	9.40	8.12	1.10	5.67	8.44	0.47
60% ACWI 20% WGBI 20% US Agg	7.23	9.26	0.76	5.29	9.29	0.40

Fixed Income

3. ***If rates continue to rise, should we abandon bonds in favor of other asset classes with more return potential? If we're not going to abandon bonds entirely, what should our asset allocation within fixed income look like?***

The most common investment objective across our client base is the "Preservation of Purchasing Power". With that in mind, fixed income is typically used as a ballast for an investment portfolio. As displayed in the graphic below, bonds can have a large impact on the drawdown a portfolio experiences during a market sell-off due to their low correlation to equities. As a result, we believe fixed income is a necessary asset class in almost every portfolio.



Source: JP Morgan

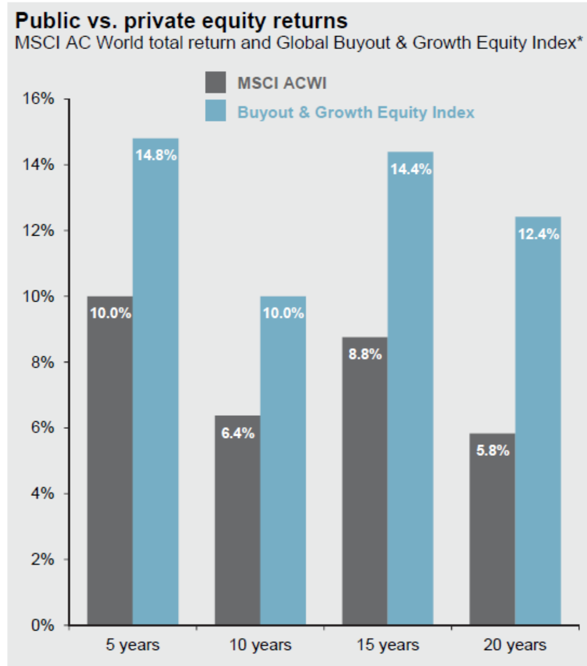
In an attempt to negate the negative impacts of rising interest rates on bonds, many different tactics can be employed within the fixed income allocation including shortening of portfolio duration, increasing exposure to floating rate and/or higher yielding securities, or diversifying geographic exposure to name a few. While the investment objectives and risk tolerance differs from client to client, we advocate diversification within fixed income away from a traditional core strategy with typical Bloomberg Barclays U.S. Aggregate-like duration.

Alternative Investments

4. ***Are there new asset classes that we should be looking at other than equities and fixed income?***

Alternative investments, such as hedge funds, private equity or private real estate, can further diversify a portfolio. These types of strategies typically have characteristics that can improve a portfolio's overall performance over the long-term including differentiated returns and low correlation to traditional asset classes, potential low net market exposure and the ability to invest in less efficient markets. While the exhibit below shows that an index of global buyout and growth equity strategies has outperformed public equities over recent trailing time periods, hedge fund strategies have not experienced the same success. With the return of volatility in capital markets, hedged strategies such as long/short equity should be able to capitalize on the rising dispersion across traditional asset classes and could be additive to overall portfolio attribution in the future.

In order to achieve long-term success with Alternative Investments, a commitment and long-term view of these asset classes is needed. Increased due diligence efforts with an emphasis on operational due diligence is also required. Before recommending inclusion of alternative investment vehicles into our clients' portfolios we make sure that our clients are fully informed of and comfortable with the risks associated with each alternative asset class and each investment vehicle considered. These risks include but are not limited to excess volatility, low liquidity, high management fees, etc. Risk tolerance is subsequently a primary determinant of a client's allocation to the alternative investment asset classes. As minimum investments are often higher in the alternatives space, the asset size of an individual client is also a large factor.



Inflation

5. ***I've read about the threat of inflation. What can we do to protect our portfolio from a higher future pace of inflation?***

We wrote extensively about inflation in a recent ACG Insights piece titled "Protecting Your Portfolio from Rising Inflation". In this article we wrote about the causes of inflation, the resulting effect of inflation on investment portfolios and finally provide some examples of how to hedge against the negative effects of rising inflation.

Overall, we counsel our clients to structure their portfolios based on their particular investment objectives and risk tolerance. To this end, different portfolios have different needs for hedging inflation. For example, a portfolio with cashflows that are sensitive to inflation would have a higher need for inflation hedging than a portfolio that does not have inflation sensitive cashflows. Over the very long-term, stocks and other risk assets can outpace inflation and can be relied upon for growth above the rate of inflation in mandates with return objectives linked to inflation (*CPI + X%*). On the other hand, investors wanting to hedge inflation risk should consider adding inflation sensitive assets to a portfolio comprised of traditional assets. A constant allocation to a broad basket of real-return assets such as commodities, gold, TIPs, and REITs provides positive inflation hedging benefits without adding unnecessary risk in environments of rising inflation.

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