Seeking Predictability in an Unpredictable World

How an increasingly complex world is changing how we can, and do, invest

What's inside

1. Introduction
2. Why indexing still works
3. The problem with traditional guardrails
4. Alternatives as modern guardrails
5. Conclusion and key takeaways

INTRODUCTION

As the U.S. economy struggles and financial markets continue to twist and turn, many investors are taking a fresh look at their portfolios and asking themselves: *Am I prepared for what's ahead?*

Actively managed mutual funds and passive, index-tracking strategies both appear to have lost some of the luster they gained over the decade-long bull market. Traditional approaches to diversification have largely failed to provide adequate downside protection, and sky-high inflation threatens to seriously erode future purchasing power. Investing for retirement has become especially problematic, as evidenced by a spate of newly proposed 401(k) regulations aimed at encouraging workers to save more, along with warnings that it's time to "crash proof" our retirement savings.

In late 2022, U.S. stock market volatility reached its highest level in fourteen years, making outcomes less predictable than they have been since the Great Financial Crisis and recession. Year-to-date as of September 1, 2022, the S&P 500 moved more than 1% in either direction on more than 87% of all trading days.

The goal of this paper is to help you identify the most pressing issues facing investors in the months and years ahead, separate emotions from the signals the market and economy are sending, and offer some novel approaches to hitting the target without abandoning time-tested strategies that have demonstrated long-term effectiveness.

Most importantly, it offers an alternative to holding cash on the sidelines when tax-loss harvesting promises to add new liquidity to many equity-focused portfolios. The challenge is timeless—capturing the market's gains while guarding against losses that derail long-term investing goals.

SOMETHING OLD: INDEXING

The active versus passive management debate is far from over, but there's no denying the fact that there has been a dramatic shift in the way Americans are investing.

Today, 67% of all U.S. mutual fund assets are held by active portfolio managers compared to 83% back in 2008. Net flows into index-tracking mutual funds and ETFs totaled $5.2 trillion from 1995 to March 2020, while actively managed funds brought in just $1.8 trillion.[1]

What's driving this migration? The Fed points to three primary catalysts:

1. Data showing that active managers often underperform the market.[2]
2. Regulatory and market pressure on fees charged by active fund managers.
3. The introduction of hundreds of low-cost index funds and ETFs that made passive investing more viable and accessible to individual investors.

Transparency and Tax Advantages

In addition to its cost advantages over most actively managed equity portfolios and the sector diversification it provides, tracking the S&P 500 Index offers transparency. Holdings and positions are continuously updated by index providers like Standard & Poor's and are available on the web for investors and the public to view at their convenience. Indexing is also considered more tax efficient because turnover is low, which limits the capital gains taxes that occur when appreciated assets are sold.

At the end of 2022, the S&P 500 Index had returned an average of roughly 14.7% each year for the past decade and 10% annually for the past 30 years. Therefore, it continues to offer advantages as the cornerstone of long-term investing portfolios. Although past performance does not guarantee future results, the nature of S&P 500 Index returns has led one popular investing

[1] Source: Federal Reserve using Morningstar data.

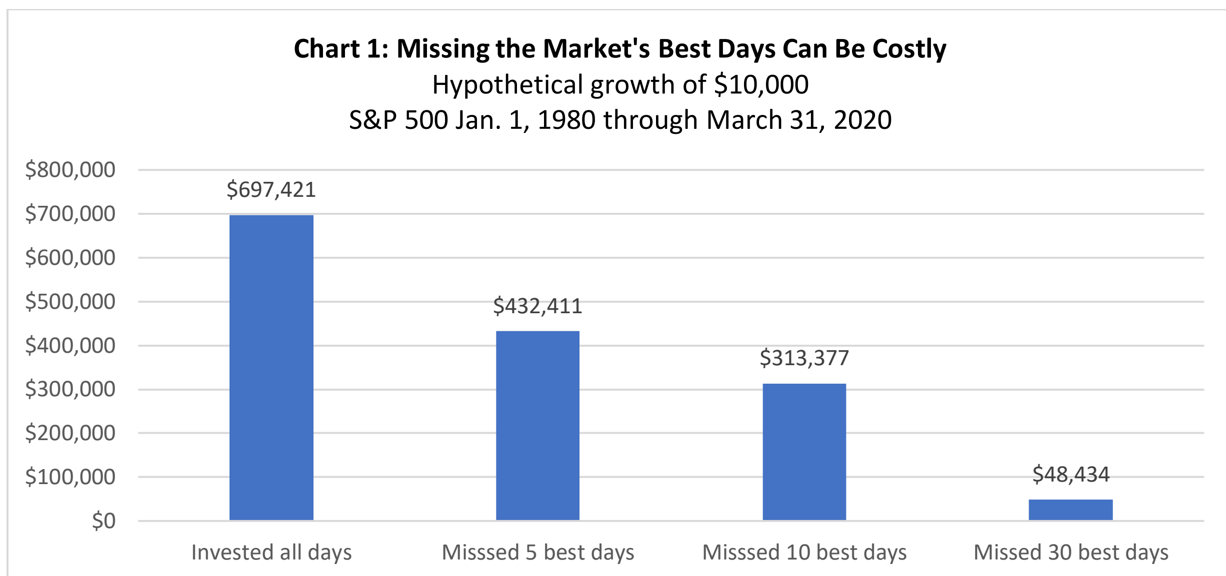
[2] Index-tracking funds are not guaranteed to outperform any actively managed fund.

website to call S&P 500 indexing "shockingly reliable."

Critics have warned that tracking the S&P 500 Index by its very definition tends to inflate large-cap stock prices, as reflected by P/E ratios. Some indicators support this hypothesis, while others show that valuations in late 2022 were far from their historical peak. Index investing also rose to prominence during the longest bull market in U.S. history, which began in 2009 and continued through 2021.

But the performance of the S&P 500 Index over the past 30 years demonstrates the value of steady participation, especially during the early days of a market rebound (see Chart 1).

The old adage is true: Time in the market is more effective than timing the market. That's because the market's best days often come on the heels of its worst days.



Source: SafeGuard Asset Management
For illustrative purposes only. It is not possible to invest directly in an index.

Earning More by Losing Less

History has proven that the key to capturing rebounds in the U.S. stock market is remaining consistently invested. But avoiding dramatic losses is equally important.

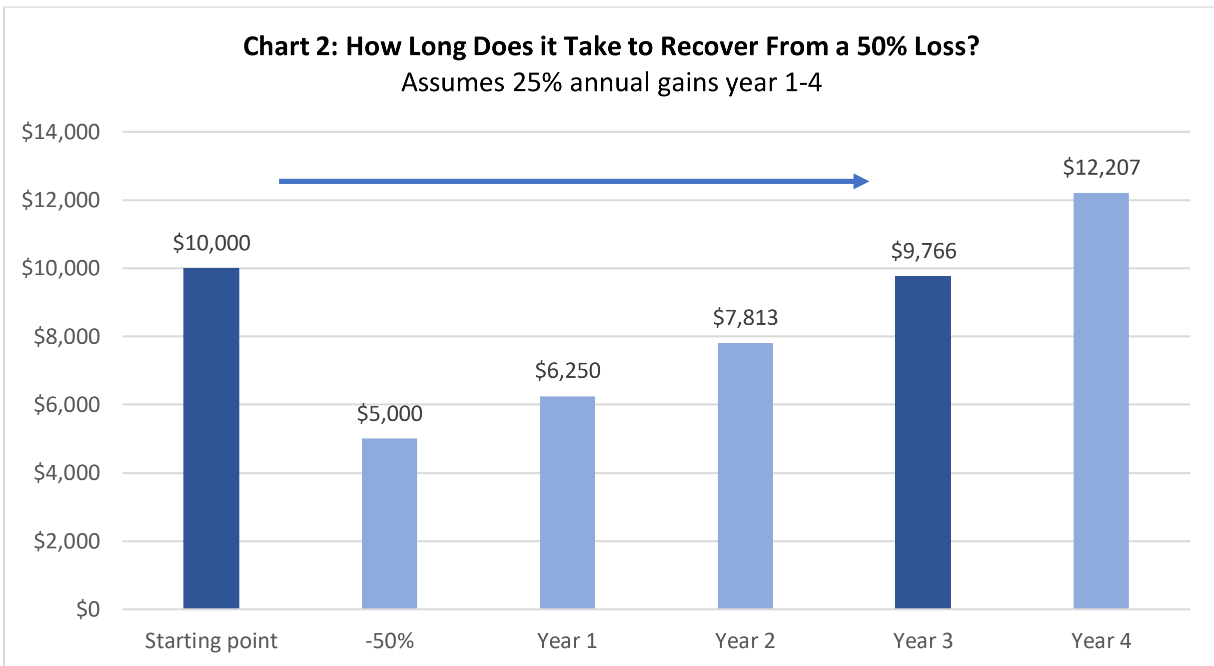
This is one area where common misperceptions and human nature can cause problems. For example, some investors assume that if the value of their portfolios fall by 50% one year, they can make up for that loss with a

50% gain the following year. But the truth is that the only way to regain the full value of your portfolio after losing half its value one year is to earn *twice as much the next year—a 100% return*.

The same principle holds true, to a lesser degree, when losses are not as steep (see table below). But in all cases, breaking even requires a higher percentage gain than the percentage of your loss.

Let's look at this phenomenon another way. In order to fully recover from a 50% loss in a $10,000 portfolio, it would take more than three consecutive years of 25% gains just to get back to where you started (see Chart 2).

Annual loss	-10%	-20%	-30%	-40%	-50%	-60%	-70%
Return needed to break even the next year	+11%	+25%	+43%	+67%	+100%	+150%	+233%



For illustrative purposes only.
Source: SafeGuard Asset Management

Beware of ‘Loss Aversion’

In today's constantly changing world, many investors are driven by a deep desire for predictability and stability. We long for the financial and emotional protection that comes with knowing what to expect from our investments.

Unfortunately, this sometimes leads to distortions in our view of risk and reward—a phenomenon in the field of behavioral finance called “loss aversion.” In essence, loss aversion means that investors feel the pain of loss more intensely than they feel the joy of gains. As a result, investors who rely solely on historical returns as the basis for their investment choices often sell prematurely and lock in losses during market corrections that ultimately turn out to be temporary.

However, there are some practical strategies that investors can use to overcome their natural inclination towards loss aversion by adding “guardrails” to their portfolios. These guardrails can buffer portfolios against dramatic losses, allowing investors to remain disciplined and loyal to their long-term plans during market turbulence. In other words, guardrails can help investors avoid loss aversion, move toward their goals, and ultimately be more successful.

Upside and Downside Capture Ratios

One way to measure the performance of a mutual fund compared to its benchmark in bull and bear markets is to find its upside/downside capture ratio. These ratios show you what percentage of the index’s gains a mutual fund captured during periods of market strength (higher is better) and how much of the index’s losses it captured during market downturns (lower is better).

For example, an upside capture ratio of 90 would mean the fund returned 90% of the benchmark’s return in an up market year, and a capture ratio of 110 would mean the fund returned 110% of the benchmark’s return (10% more than the benchmark) in a year of positive market performance.

Conversely, a downside capture ratio of 90 would mean the fund outperformed the benchmark during a period of market losses because it captured only 90% of the benchmark’s loss. Most mutual funds use monthly performance data to calculate upside/downside capture ratios but report them in 1-year, 3-year, 5-year, 10-year and 15-year periods.

Funds that outperform their benchmarks
in both up and down market cycles are
exceedingly rare.

THE PROBLEM WITH TRADITIONAL GUARDRAILS

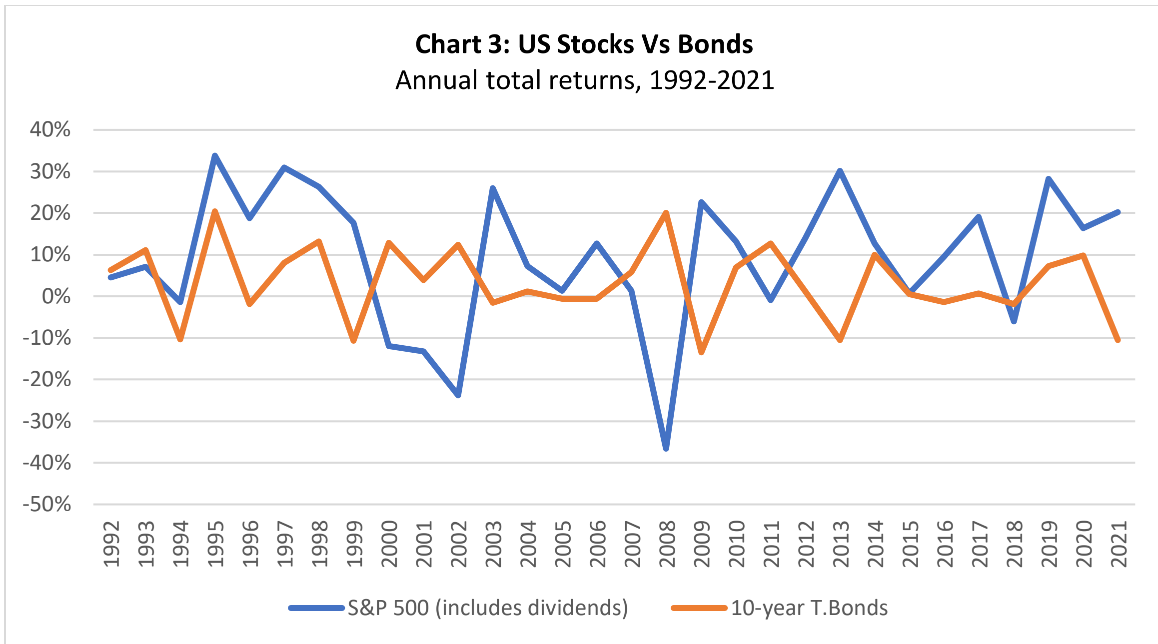
For true portfolio diversification, look beyond 60/40 allocations.

One of the most common tools investors use to buffer portfolios against sharp downturns is diversification—adding exposure to a variety of asset classes that have historically moved in different directions under a certain set of market conditions. Ideally, losses in one asset class are offset or moderated by gains in another category. So, diversification can serve as a portfolio "guardrail."

Not so long ago, a simple rule of thumb was to diversify by allocating 20% or 30% of an equity-centered portfolio to something considered defensive and showing uncorrelated returns, like U.S. Treasury bonds. Historically, the performance of the Treasury bond market has shown an inverse relationship to stocks (it moved in the opposite direction). From 1965 through 2000, the bond market was generally rising when the stock market was declining, and vice versa. So, bonds served as a guardrail to keep equity portfolios from running off the road and wrecking long-term investing plans. But that relationship lost strength in the mid-2010s, and the two markets started moving in tandem more often, thanks to a variety of unusual geopolitical and economic factors (see Chart 3).

Most recently, U.S. Treasuries largely failed to serve as an effective safety net during market selloffs in March and September of 2022.

But Treasury bonds can still make valuable contributions to diversified portfolios. As interest rates rise, so do bond yields. So, bonds can provide a steady stream of current income, especially when interest rates are rising. U.S. Treasury bonds are considered one of the lowest-risk investments in the market because they are backed by the full faith and credit of the U.S. government, which guarantees the return of your initial investment upon maturity. Therefore, Treasury bonds offer the potential to preserve capital and provide income that enhances portfolio returns.



For illustrative purposes only. It is not possible to invest directly in an index.
Source: Stern NYU

Fighting Inflation

After virtually disappearing for years, inflation in mid-2022 was driving up retail prices at the fastest rate in nearly 40 years, hitting a record high of 9.1% in June. Inflation is cyclical. But at this rate, investors would have to earn a 9.1% return on their investments just to keep up with inflation and maintain the purchasing power of their savings.

One investment that is designed specifically to serve as a guardrail by fighting inflation is Treasury Inflation-Protected Securities ("TIPS"). TIPS are U.S. government bonds with interest payments that are adjusted to keep up with inflation. When TIPS mature, investors receive 100% of their initial investment. But even in this ultra-high-inflation environment, total returns on TIPS (price changes plus interest payments) were -13.2% for the first nine months of 2022. The sticking point many investors do not realize is that TIPS must be held to maturity (5, 10, or 30 years) in order to keep up with inflation and maintain purchasing power. In the meantime, TIPS prices and the value of all bonds fall as interest rates rise, subjecting investors to the detrimental effects of the loss aversion behavior referenced earlier.

Shorting Stocks is Risky

Another traditional guardrail that can be used to manage downside risk in the equity market is short selling. In simple terms, short selling initially involves borrowing stocks and immediately selling them at current market prices. If the price of the stock drops, the investor

then buys them back and returns them to the lender at a profit.

Shorting becomes more profitable as the value of the underlying investment declines, and is a technique commonly used by managers of long/short mutual funds. They hold long positions in the market and use shorting to hedge their bets in case the market takes a turn for the worse. But short selling is not for the faint of heart. It carries almost unlimited risk because the price of a stock can theoretically rise indefinitely, is expensive because you must pay interest to the lender of the shares, and has limited reward potential because the price of a stock can only fall to $0.

SOMETHING NEW: ALTERNATIVES AS MODERN GUARDRAILS

Guarding against dramatic losses when the market stumbles and capturing growth when it rebounds are not mutually exclusive goals.

The term "alternative investments" refers to a broad universe of asset classes and trading strategies outside the world of traditional stocks and bonds. It includes investments that were once solely the domain of hedge funds and large institutional investors—asset classes such as private equity, real estate, derivatives such as futures contracts, commodities, and foreign currencies.

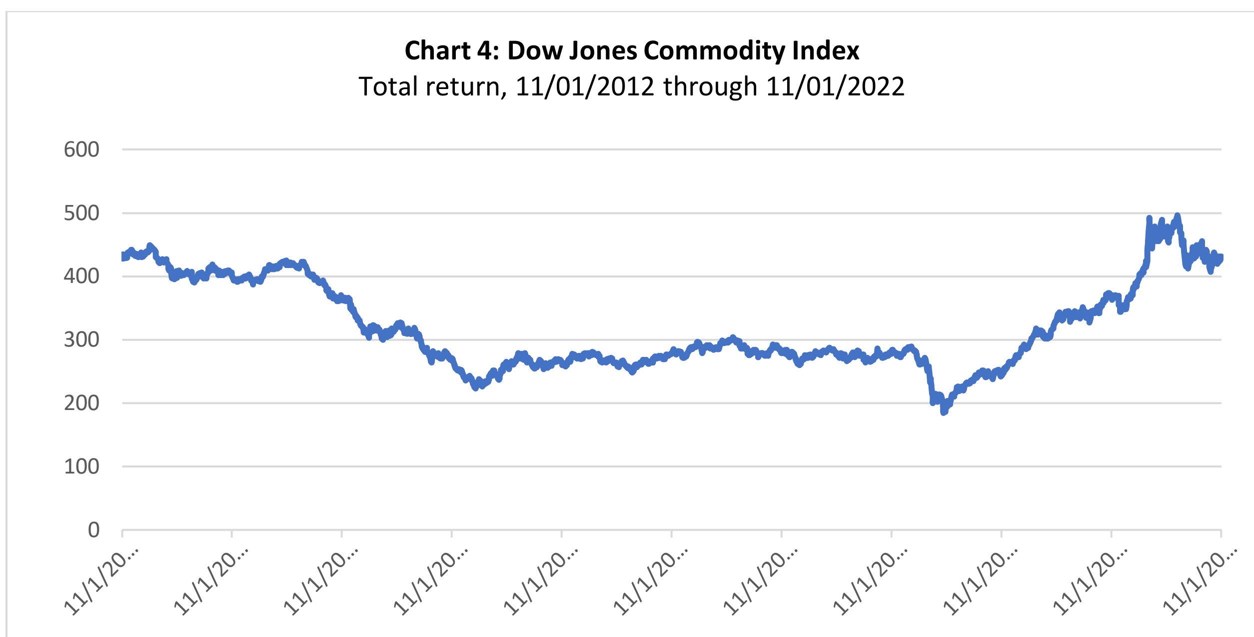
These types of complex investments were once available only to institutions and the most sophisticated (accredited) individual investors through hedge funds. Hedge funds are private investments, typically structured as limited partnerships, and therefore they are not as heavily regulated as traditional mutual funds. Because hedge funds often hold assets that are less liquid than stocks and bonds (they can't be bought and sold as easily), they usually impose "lock-up" provisions or holding periods that restrict an investor's liquidity and access to capital, possibly for years. It is not uncommon for hedge funds to impose minimum investment requirements of $1 million or more, charge a 2% management fee, and retain 20% of all realized investment gains.

Today, individual investors have access to a wide range of alternative investments via traditional mutual funds that are fully transparent, offer daily liquidity, and carry modest fees. These investments also carry additional risks, but they can play an important role as

guardrails because their performance tends to have a low correlation to traditional stocks and bonds, often moving in the opposite direction. In addition, real assets such as gold and other precious metals have demonstrated their effectiveness as a hedge against inflation.

Whether an investor is interested in real estate, private equity or commodities, traditional mutual funds now provide convenient access to many diverse and complex asset classes.

Overall, this increased access to sophisticated alternatives has made it easier than ever for individual investors to diversify their portfolios, guard against dramatic losses, and maximize return potential in any economic climate.



Source: S&P
It is not possible to invest directly in an index.

Commodities and Currencies

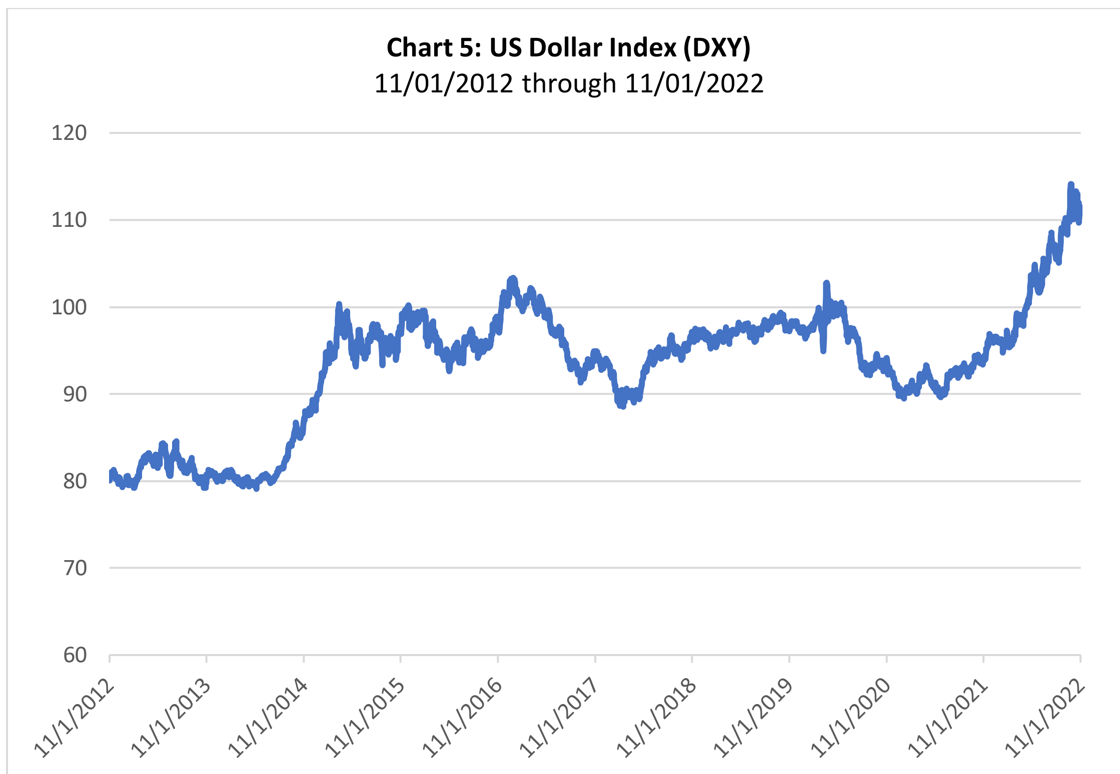
Commodities and foreign currencies are just two examples of alternative investments that are easily available through mainstream mutual funds. And they have both demonstrated their effectiveness as portfolio guardrails when the U.S. stock and bond markets were underperforming. Please keep in mind that commodities and currencies are complex investment that carry heightened risk. Professional management of these asset classes is strongly advised.

Historically, the performance of the commodities market has tended to increase when inflation is rising and geopolitical tensions are high—two conditions that typically work against the stock market. The Dow Jones Commodity Index, which is a broad measure of the commodity futures market, was up more than 17% through early November of 2022, while the S&P 500 Index was down 21.3% (see Chart 4).

Economic uncertainty also tends to expose opportunities in global currency markets, as evidenced by the robust performance of some currency hedge funds during the global financial crisis of 2008.

Conditions aren't as stark today as they were in 2008, but economic stressors recently lifted the value of the U.S. dollar to a 20-year high (the U.S. dollar is often considered a safe haven when the stock market is slumping) and drove the Japanese Yen to a 32-year low.

The U.S. Dollar Index, a broad measure of U.S. dollar performance versus a basket of foreign currencies, gained 12.4% through mid-November of 2022 (see Chart 5). Global currencies can be bought and sold directly through the foreign exchange (Forex) market (one of the largest and most liquid markets in the world) or traded through futures contracts.

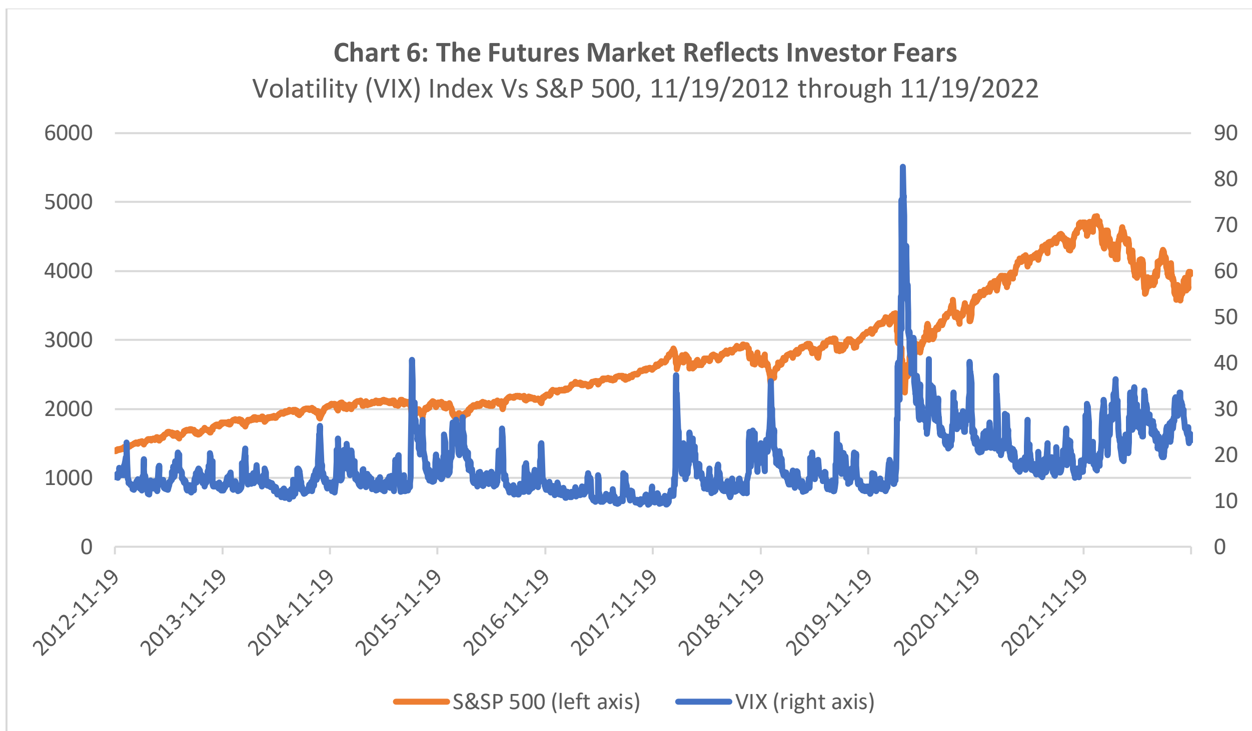


Source: Investing.com
It is not possible to invest directly in an index.

Investing in Futures

One of the most popular ways to invest in commodities and currencies is through the futures market. Buyers of futures contracts agree to purchase an underlying asset and sellers of futures contracts are obligated to deliver the underlying asset at some predetermined future date. Futures contracts are available for a wide variety of underlying asset classes, including U.S. and global equities, commodities, and foreign currencies. One of their strengths is that they can be bought for a fraction of the underlying investment's market price (10%).

Investing in futures is a complex discipline that is considered speculative and carries additional risks. However, adding futures contracts to equity-centered portfolios can offer many advantages for certain investors, both as guardrails to hedge against dramatic losses during equity market fluctuations and as an opportunity to enhance portfolio returns when managed by experienced professionals who specialize in futures trading.



Source: CBOE and Federal Reserve Bank of St. Louis
It is not possible to invest directly in an index.

Anticipating Volatility

Historically, the S&P 500 Index futures market has been one of the most reliable indicators of where the U.S. stock market is heading (see Chart 6). S&P 500 futures are also one of the most widely traded types of futures contracts, and the Chicago Board Options Exchange ("CBOE") uses trading patterns to create its well-known Volatility Index ("VIX"), which shows expectations for market volatility over the following 30 days.

The VIX has demonstrated an inverse relationship to the S&P 500 Index with a 68% confidence level, according to the CBOE.

Therefore, the VIX is often considered a reflection of investor fear—and it was up more than 71% through mid-October of 2022 as the U.S. stock market struggled. The opposite trend was seen in 2021 when the VIX lost -24.3% as the U.S. stock market gained almost 27%.

In our view, the futures market offers a cost-efficient way to participate in the growth potential and risk-management features of a wide variety of asset classes (both traditional and alternatives) and geographic markets.

Using Puts as Guardrails

Another modern-day guardrail that is somewhat similar to futures contracts is the options market. One of our favored strategies is buying "put" contracts, which gives the buyer of the contract the right (but not the obligation) to sell an underlying investment at a predetermined future date for a specific price called the "strike price."

If the value of the underlying investment declines, the owner exercises the contract, sells the investment at the predetermined (higher) price, and is rewarded with the price difference between what he paid for the investment and what he sold it for (minus the cost of the put option itself). On the other hand, if the value of the underlying investment appreciates, the put expires worthless and the owner's loss is limited to the modest cost of the put.

Like the futures market, options such as put contracts are complex investments and carry additional risks. But when managed by experienced professionals , we believe put contracts offer a much more attractive alternative to hedging portfolio risk than short selling and can serve as a cost-effective guardrail against dramatic losses in equity-focused portfolios.

CONCLUSION
INDEXING + ALTERNATIVES THE FUTURE OF INVESTING?

In today's constantly changing world, many investors yearn for predictability. This isn’t surprising. It is human nature to seek out comfort and stability in our lives.

So, it is natural for many of the decisions investors make to be driven by these same emotional tendencies rather than dispassionate, critical analysis. In our view, this is one of the most profound (and often underappreciated) benefits of professional portfolio management—the ability to recognize emotional traps and offer innovative, new ways to help investors avoid them.

In our view, the formula for long-term success in this uncertain environment adds the growth potential of tried-and-true investing strategies like indexing with modern and sophisticated guardrails to prevent investors from veering off course.

Key takeaways

- Stock market indexing has proven its effectiveness as a long-term growth strategy. But sharp, temporary drawdowns can test the patience of even the most disciplined investors.
- Treasury bonds aren’t as effective as they once were for portfolio diversification, but they are unsurpassed in their effectiveness as a capital preservation tool.
- In our view, the best guardrails to defend equity-centered portfolios against dramatic losses are non-correlating alternatives, managed by specialists in their fields.
- Managed futures contracts, which are available now within mutual funds as an alternative investment, provide a cost-efficient way to invest in the U.S. stock market. Their advantages include managing portfolio risk and an opportunity to enhance long-term returns.

Important risk information

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty.

Commodities contain heightened risk including market, political, regulatory, and natural conditions, and may not be appropriate for all investors. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation, and liquidity risk.

Bond and bond strategy values are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed.

Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. In addition, commodity-linked derivative instruments may involve additional costs and risks such as changes in commodity index volatility or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Investing in derivatives could lose more than the amount invested.

Trading security futures contracts may not be suitable for all investors. You may lose a substantial amount of money in a very short period of time. The amount you may lose is potentially unlimited and can exceed the amount you originally deposit with your broker. This is because futures trading is highly leveraged, with a relatively small amount of money used to establish a position in assets having a much greater value.

Investments in currencies involve additional special risks, such as exchange-rate risk related to unpredictable gains or losses due to changes in the value of one currency in relation to another currency.. Derivative investments in currencies can be volatile, and these investments may be less liquid than other securities and more sensitive to the effect of various economic conditions.