ABR Dynamic Funds' Portfolio Construction Series: Part 24 – Conclusion

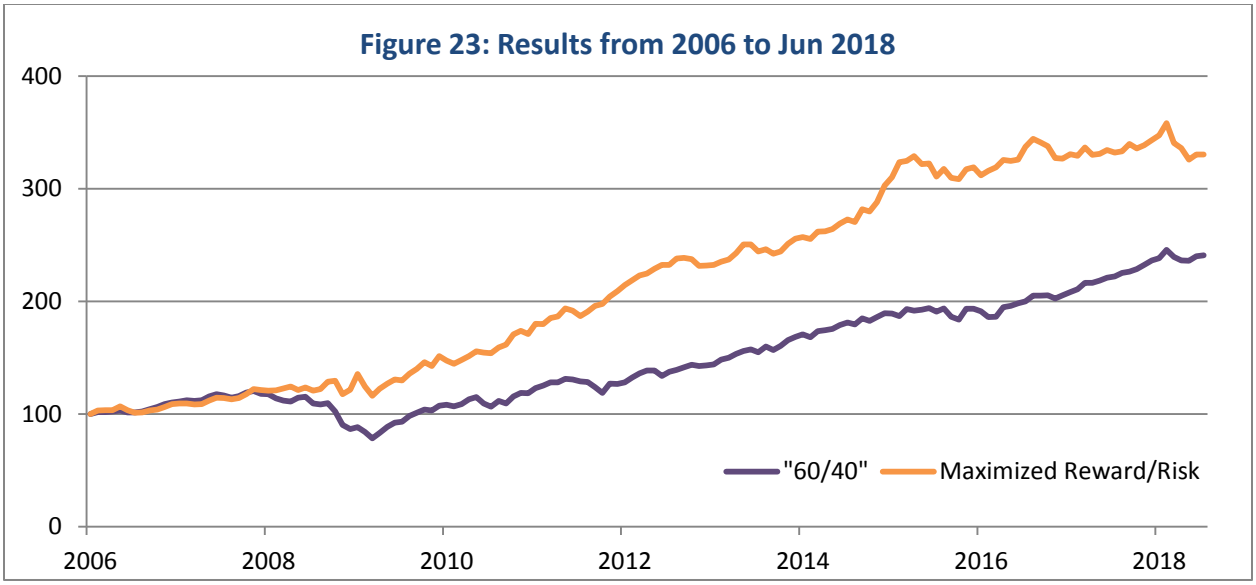
Results, Rebuttals, and Closing Summary

Installments 19-23 explored a simple approach to a better method of portfolio construction that was first published over half a century ago:

1. Maximize the reward for every dollar put at risk in a portfolio
2. Scale all allocations up or down to target a desired level of overall risk

Results

The results were a significant improvement over those of "60/40" by any reasonable measure. From installment 21, the following graph (Figure 23) and statistics (Table 7) show the results of "60/40" compared to the results of (1) maximizing the reward for every dollar put at risk and then (2) scaling the allocations to target the same risk as the "60/40" portfolio.



Source: ABR White paper (data from Bloomberg)

Table 7 Jan 2006 - Jun 2018	"60/40"	MAXIMIZED REWARD/RISK
Annualized Return	7.29%	10.04%
Annualized Volatility	8.98%	8.98%
Sharpe Ratio	0.66	0.97
Maximum Drawdown	34.8%	14.2%
"SPY" Allocation	60%	57%
"TLT" Allocation	0%	30%
"LV" Allocation	0%	66%
"MF" Allocation	0%	22%
COREPLUS Bond Allocation	40%	0%
Leverage	0%	75%

Source: ABR White paper (data from Bloomberg)

Rebuttals

Despite the long history of academic research and the better results of this method, some investors still choose the concentrated equity exposure of "60/40" (see installment 18 for why "60/40" has actually behaved more like 80% equity exposure). Aside from how easy equity investing has been during this extended bull market, a condition that cannot be expected to continue indefinitely, these investors typically note two concerns that have kept them from employing the better method, and we want to take this opportunity to respond to those concerns:

1. Is the modest level of leverage a concern?
2. Is any added complexity a concern, especially in understanding and explaining this method?

Leverage

Leverage may be a risk, but it is other considerations, which may accompany leverage, that have been the true risk. In other words, the risk isn't leverage itself, but what is actually being leveraged. For example, some leveraged strategies have lockup periods and other forms of illiquidity. Fortunately, all of the behaviors in installments 19-23 can be found in highly liquid forms. In fact, S&P 500 E-mini (electronic – miniature size) futures have typically traded about 7x as much as the top 6 equity ETFs *combined*.[i]

Installment 21 demonstrated that leverage is best viewed as a tool that can be used to set risk, not as a measure of risk. **Importantly, investors seeking a certain level of return have to take some type of risk to achieve that return. If those investors are not willing to consider the "risk" of modest leverage, then they have typically accepted the more significant risk of high concentration into equities.** Table 4 on page 3 of installment 20 compared the risk of leveraged portfolios to unleveraged ones (including "60/40"). The conclusion was clear: *more risk was required to achieve the same return without the use of modest levels of leverage.*

Finally, consider that many investors who think they are unleveraged are, in fact, already leveraged. For example, the last time the debt-to-equity ratio of the S&P 500 was below 100% was in the 1980s. Why would leverage make sense for so many companies seeking certain risk/reward profiles but not for end investors with similarly formulated targets? Given that so many investors are leveraged anyway, whether they knew it or not, it may be worth considering the advantages of proper use of modest leverage.

Complexity

The last concern of some investors is that this method is more complicated, more difficult to understand and explain than "60/40." Unlike the last concern, this one is actually real, although to a much lesser degree than it may first appear.

The entire method boils down to two simple steps:

1. **Maximize the reward for every dollar put at risk in a portfolio**
2. **Scale all allocations up or down to target a desired level of overall risk**

Do those two steps really add meaningful complexity to an investing process? Do they really add enough complexity to forgo the significantly better results of this two-step method? Before answering,

consider what must go into truly understanding the results of even just a simple portfolio of domestic stocks:

Despite being a U.S. domestic stock market index, the companies in the S&P 500 have made approximately 45% of their sales outside the U.S. in recent years.[ii] That means, **in order to truly understand the drivers of a "simple" portfolio composed just of "domestic" equities, an investor needs to understand the effects of all of the following from all over the world** on the cash flows of his/her companies:

- Consumer spending
- Competition
- Materials, labor, and transportation costs
- Interest rates
- Regulations, taxes, and tariffs
- Managerial decisions
- *Just to name a few*

But that's not even the end of it. A company's stock return on a given day then depends on guesses of those cash flows in the future, as the elements influencing them are constantly changing. To tackle this problem, some investors analyze balance sheets; others calculate "factor" exposures; still others track sentiment; etc. However, even after accounting for everything, the best explanation of much of short-term returns is still just noise, or random variance.

This discussion raises the possibility that much of the perceived understanding of equity market returns is an illusion created by the fact that they are on TV every day, along with usually ridiculous stories attempting to explain them. *However, seeing the returns and understanding them are two very different things.* When it comes to understanding investment results, **we don't think the two extra steps of this method add meaningful complexity to the already complicated process of truly understanding and explaining investment results**, certainly not enough to forgo the better results.

Closing Summary

Finally, we end by summarizing the observations from installments 20-23 on constructing a portfolio that has maximized the reward for every dollar at risk:

1. The term "core" was a misnomer. Low correlation (not just low beta) "alternatives" were a significant part of the best portfolios.

2. Proper diversification means usually hating at least one allocation. Not all allocations are designed to win at all times, and it is the manner in which allocations have complemented each other throughout various market conditions that has improved portfolios.

3. Leverage was a poor measure of risk but a useful tool for dialing risk up or down to targeted levels.

4. From a baseline of a well-diversified portfolio that maximizes reward for every dollar at risk (not "60/40"), large adjustments to allocations, in anticipation of a particular market condition, have been risky. The level of certainty in a market outlook that would be necessary to warrant large adjustments is a very high bar.

5. Other component behaviors and other geographies, as well as optimization over other time frames (that still incorporate full market cycles/various market conditions), may be useful for investors who are concerned about new regimes in the future, such as an extended period of inflation or an extended period of stagnation.

6. Once the component behaviors have been selected, and it is time to select specific investments to gain exposure to those behaviors, diversification is probably still the best course of action. The alternative of searching for lasting alpha has often been fruitless.

This concludes the introduction to portfolio construction. Please contact us at info@abrfunds.com with any questions, comments, or other interesting topics we may have overlooked in this series.

[i] The notional value traded in the first two Emini S&P 500 futures contracts was 7.036 times the notional value traded in SPY, IVV, VTI, VOO, VEA, and QQQ combined from 2016 – April 2019. ETFs selected are the top 6 by AUM on ETFdb.com at the time of this writing. Data source: Bloomberg.

[ii] According to S&P DJI's Foreign Sales Report, foreign sales accounted for 47.8%, 44.3%, 43.2%, and 43.6% of total S&P 500 sales in 2014, 2015, 2016, and 2017 respectively.