Swiss Cheese Diversification
By Alan Snyder

Swiss cheese, the one with the holes in it, usually adorns a corned beef or pastrami sandwich on rye slathered in Russian dressing and, you may think, has little to do with investing. However, we are going to use this imagery to safety-proof our portfolios (and don't let any hunger pangs that we may trigger, overwhelm). Simply put, most portfolios and their individual positions are not truly diversified but can be likened to stacking individual slices of Swiss cheese with their holes lined up, a leaky affair. Alternatively, slices of Swiss cheese randomly arranged have many holes but will allow returns to filter carefully through. It is this end stacking result we seek for a well-diversified and safe, yet stable return, portfolio. Never more than in these challenging times have the merits of diversification been needed. There is a "two-fer" of risk impacting both equities and fixed income (think 60/40 equity and fixed income portfolios).

Equities

1. The rolling 10-year DJIA performance through 2019 was one standard deviation from the index average over the past 110 years. FYI, +1 standard deviation occurs 32% of the time, assuming a normal distribution. However, a normal distribution may not accurately reflect investment returns when there are many outliers (fat tails), i.e., maybe there is substantially more risk. Adding in 2020 results makes this picture more fraught - Gulp!

2. The Fed is buying $120 billion of securities per month. Its balance sheet is measured in trillions, about $7 trillion now - Look out below!

3. Most economists believe that the combination of Fed policy and fiscal stimulus without regard to debt levels has nowhere to go but into equities. However, if earnings are not materially higher than pre-COVID levels, have equity owners a more valuable income/cash flow stream, even projecting further recovery in one to three years? Should there be a discount rate versus an increasing multiplier (i.e., P/E ratios)? Holy smokes!

4. The forward price/earnings ratio stands at 22.2x in early December 2020 versus the historic average of 15.4x. The illustrious Shiller CAPE P/E ratio is roughly 33% higher than the 20-year average, implying a 1% future annual return - Nosebleed levels?

Fixed Income

1. Since the 1980s, the 10-year Treasury rate has dropped from 16% to less than 1%. Upside?

2. In March 2020, the Fed reduced its target rate's lower bound from 1.25% to 0% and discounted any push for negative rates. Gains seem unlikely.

3. Current inflation is higher than the 10-year Treasury rate. Slow value destruction.

"Smart" Money Response

These facts have triggered a response from pension consultants and super-sized pension managers who are able to buy all manner of investment expertise.

1. Wilshire Consulting lowered their 10-year future return expectations to: U.S. stocks, 5.5% - Long-term bonds, 1.75% - Illiquid P/E, 7.45% - Real assets, 5.3%.

2. Both the Florida Retirement System and the California Public Employees Retirement System (a.k.a. CalPERS) have set 7% as their target return. Yet for perspective, CalPERS 10-year average return has been 4.32%.

3. The outperforming Yale Endowment solution: 5% public equities, 6% mainstream bonds, 89% alternatives and other asset classes.

4. Harvard, no performance slouch, allocates 60% to hedge funds and other asset classes (broadly speaking, alternatives). Now that we have embraced Kierkegaard and his Fear and Trembling, we must arrange the cheese slices of our portfolio positions with forethought and recognition that any construct is specific to each of us. Two matrices should be considered to score both ourselves and each individual position in order to limit cross correlation, the enemy of diversification. How will each position perform under the following?

    a. Economic expansion/contraction
    b. Inflation/deflation and even stagflation
    c. Geopolitical exposure
    d. Macroeconomic scenarios, natural, political and fiscal impact on a regional or national economy

Thus armed, what is our unique psychological makeup?

a. Tolerance for risk
b. Demand for return/yield
c. Time expectation
d. Liquidity needs/requirements

Doing the scoring described above may seem daunting, but ruminating on it will help guide our portfolio "mix" of positions and does not demand decimal-level precision.

One cautionary thought cried out to me while writing this: Beware the allure of derivatives and volatility hedges. As a young lad, I spent years running an options department for a major Wall

Street firm - or maybe it was running me. Ever since, that space has been interesting but approached only on little cat feet. Those events which we are told only happen once every 50 - 100 years to destroy performance seem to occur much more frequently. The ugly result has been wiping out the then-current practitioners and their investors. For sure, short volatility strategies and hyper-leveraged ones are the most dangerous.

On a happier note, we agree with Yale and Harvard that carefully selected alternatives can mitigate risk and provide attractive returns. As regular readers know, our particular prejudice is "nichey" alternatives. The unfortunate corollary is that finding them takes work - but always best in the company of a Swiss cheese, pastrami sandwich on rye, hella good.