Future-proofing 2.0 – portfolios put to the test

RECENT MONTHS HAVE SHOWN ONCE AGAIN JUST HOW QUICKLY THE WINDS CAN SHIFT IN THE FINANCIAL MARKETS – A HUGE WAVE OF SELLING IS FOLLOWED IN THE BLINK OF AN EYE BY A SURGE IN THE OTHER DIRECTION, LEAVING INVESTORS TO WONDER WHETHER BOTH ANOMALIES WERE EXAGGERATED. HOW SHOULD INVESTORS REACT TO SUCH GUT-WRENCHING CHANGES IN THE WEATHER PATTERNS ON WALL STREET AND ELSEWHERE? OUR ADVICE IS TO STRUCTURE ONE'S PORTFOLIO IN A WAY THAT IS AS WEATHER-RESISTENT AS POSSIBLE AND TO CONSIDER THE PARTIAL HEDGING OF EQUITY RISKS.

Future-proofing 1.0

In September 2018, the far-advanced bull market, increasing risks and signs of changes in the overall investment environment prompted us to launch the initiative "Future-Proofing Portfolios: Get Your Portfolio Fit for the Future". In anticipation of more turbulent times, we recommended positioning the portfolio properly for the late cycle, i.e. by means of a comprehensive check. This was followed in October by a rapid shift in equity market sentiment, from which the credit markets were not spared. Not only did a price and valuation correction ensue, but also a greater awareness of risk. Has this made the concept of "future-proofing" obsolete?

Where do we stand today?

Even though the equity markets took a dive towards the end of last year and investors' nerves were strained to the limit, very little has actually changed in terms of the fundamentals. From a global perspective, the slump was merely a correction within the framework of a primary uptrend, and the bull market remains intact. The future challenges outlined in our study still exist and have yet to be resolved, but they have certainly moved closer to investors' conscious level.
It lies in the very nature of the stock markets that precipitous price declines normally occur very abruptly. A typical recovery, on the other hand, also starts with marked daily fluctuations but then quickly settles down and proceeds at a more leisurely pace. So all the more surprising is the rapid, straight-line recovery we have witnessed since the turn of the year.
The decisive factor here was initially the normalisation of investor sentiment, as is quite usual after a phase of pronounced pessimism. An astonishing about-face in the Fed's posture then led to an extension of the upswing. And hopes of a solution to the trade conflict between China and the USA did the rest. Great expectations have built up from all of this – but they now need to be confirmed.

Too far, too fast?

As pleasing as the first two months of the year have been, the recovery is on shaky ground. The fundamental data do not (at least not yet) warrant the optimism. The dynamic underlying today's economic and corporate data has started to sag. Analysts and economists have tempered their expectations. In view of these factors, anyone counting on further stimulus measures from the central banks could be sorely mistaken – at least the Fed's wait-and-see attitude could soon come to an end. After all, average hourly wages in the US are currently increasing by more than 3%. If this crystallises in the form of broader-based inflation, the US Federal Reserve will get back on its rate-hike path. Should the economy fail to accelerate at the same time, the risk of disappointment looms. All of this could bring investors to the realisation that the market has grown too far, too fast. The result would be profit taking and at least a temporary recalibration.
Investors wishing to protect their recent price gains from such a setback should consider hedging. There are several ways to go about this. Since there are also some very good arguments for rising prices, it is advisable to hedge by means of a put option. The major advantage of this instrument is that investors can continue to participate in rising prices and at the same time protect all or part of their capital from a downside move. The disadvantage is that this structure is associated with costs. However, the market recovery of late has led to a reduction of these hedging costs.

Future-proofing 2.0

Already in our first study we recommended hedging. However, this should be accomplished on a situational basis, since the costs of permanent hedging significantly reduce total return. But regardless of whether or not hedging is actually undertaken, we recommend that investors subject their portfolio to a review that encompasses the following levels:

Allocation: The starting point for this allocation test is the respective weightings of the various asset classes. In particular, one's riskier investments should be brought back in line with the strategic precepts. It is important to ensure that the former are consistent with your investment objective. Naturally, for those who wish to earn income despite today's low interest rate environment, holding risky investments is practically unavoidable. This makes it all the more important to consider investment opportunities that act as a counterweight. Especially in mature bull markets, it is important to establish convexity in the portfolio.

Portfolio construction: Diversification is important not just at the asset allocation level, but also within the specific asset classes. Splitting risks and investment opportunities is a crucial element of portfolio construction. Flexible bond funds, alternative bond strategies and unconventional ways of benefitting from risk premiums represent interesting supplements.

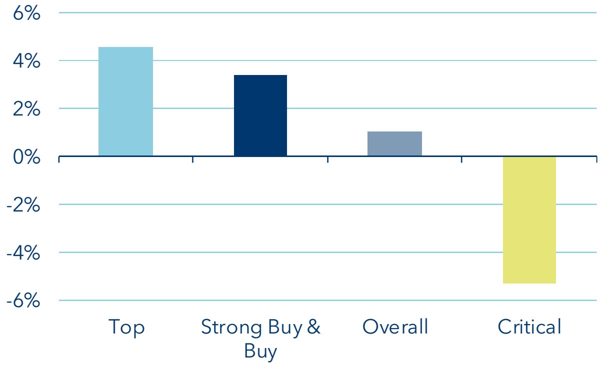
Implementation: It is of little use if all this advice is precisely adhered to but translated into action with the wrong instruments. Here too, our focus is on the risks. We have therefore defined criteria for both equities and bonds that point to poor quality. In this regard, the implementation process addresses not only the qualitative aspect in regard to the investments, but also the conceptual aspect. The latter pertains to the specific instruments and counterparty risks: i.e. from our standpoint, diversification amongst counterparties, the minimum quality standards required of those counterparties, instruments with physical backing, the "Best Manager" principle, etc.

Does future-proofing actually work?

To verify that this approach works, we have put our recommendations to the test. Although the benefits of the allocation and portfolio construction recommendations are obvious and undisputed, the result in terms of the individual securities is less clear. We therefore reviewed the performance of stocks and bonds in consistency with our ratings from last September (i.e. the publication date of our initial study). The turbulence in Q4 2018 made for a perfect acid test.

As part of our analysis, we examined around 1,500 stocks on the basis of various criteria, including their defensive price behaviour, debt burden, profitability and capital efficiency. Companies that came away poorly under these criteria were classified as "Critical" and then accorded a "Sell" rating as part of the portfolio check.

Stocks put to the test



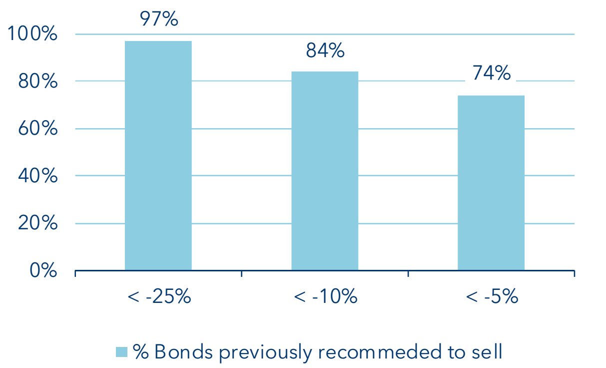
Average price development (incl. dividends) 19.09.2018 – 20.02.2019

Sources: VP Bank, Bloomberg

In the period under review, the "Critical" shares recorded the worst performance. The stocks classified as "Top", as well as our other "Buy" recommendations, clearly outperformed the average. This evaluation shows that high-quality stocks cannot escape a downward phase, but they lose less than the market as a whole.

In order to judge the quality of our bond assessments, we examined how accurately we identified those bonds that came under particularly heavy pressure in the period under review. Our approach is essentially based on a comparison of the rating agencies' form appraisals versus the forecasted default rates which we derive from our research partner's credit models. If we identify the potential for a downgrade, there is a risk – at least for the issues from less creditworthy borrowers – of a market price loss. 97% of the bonds that have declined by more than 25% since the start of our future-proofing initiative fell into this category. For bonds that retreated by 10% or more during the period, the ratio is 84%; and for bonds with a drop of 5% or more, 74%. However, it should be noted that almost two-thirds of our unrecognised bonds are issues with a particularly long duration or perpetual bonds, so it comes as no surprise that they are particularly sensitive to sea changes in the market.

Bonds put to the test



19.09.2018 – 20.02.2019

Sources: VP Bank, Bloomberg

Summary

The last few months have shown how important it is to know, identify and assess portfolio risks, especially given the late-cyclical phase in which the financial markets currently find themselves. Apart from the aspects of asset allocation and portfolio construction, it is particularly important that attention be paid to securities selection. We also recommend partial hedging by means of put options into market strength. We shall be pleased to assist you in this process so that your portfolio, too, is weatherproofed for what lies ahead in the financial markets.

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