dfs portfolio solutions

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"Every 10 years or so there is a shift to new paradigms in which the markets operate more opposite than similar to how they operated during the prior paradigm. Identifying and tactically navigating these paradigm shifts well and/or structuring one's portfolio so that one is largely immune to them is critical to one's success as an investor."
Ray Dalio[i]

THE CURRENT PARADIGM

In general, strategic asset allocation (effectively buy & hold) portfolios have been the best performers over the last 10 years. Strategic Asset Allocation (SAA) portfolios seek to optimise returns at specified levels of risk; and assume: (1) fixed expected returns, where growth assets generate higher returns than defensive assets; and (2) risk levels of assets at any given time will be in line with their long-term averages. Conservative SAA portfolios have higher allocations to defensive assets (bonds & cash) and the assertive SAA portfolios have higher allocations to growth assets (equities & real assets). The last 10 years have been rewarding to equities, real assets and bonds, which has contributed to strong performance across all risk profile portfolios. Global Quantitative Easing (QE) policies have pushed bond yields down to levels that were unimaginable a decade ago, providing bondholders and equity & real asset owners with excellent returns. Portfolios with permanent & high levels of risk have been well rewarded since 2009; and particularly so in recent years. Passive investing (i.e. buying the market) has generally been much more rewarding than active investing (buying/selling stocks to outperform the market) in this environment.

The Morningstar Risk-Profile Indexes are proxies for SAA portfolios and the table below highlights solid returns that have been generated in recent years, which has largely been deemed a "low-return" environment:

Period Returns	3 Months	1 Year	2 Years	3 Years
Morningstar M'sector Moderate Index	3.2%	8.1%	6.9%	5.8%
Morningstar M'sector Balanced Index	4.2%	9.6%	9.0%	8.2%
Morningstar M'sector Growth Index	4.9%	10.6%	10.5%	9.8%

The above returns are even more impressive considering that (CPI) inflation has averaged less than 2% p.a. To highlight, a real return of over 6% over 12-months for a moderately conservative portfolio is exceptional and not indicative of what to expect from such portfolios. Indeed, many asset allocators suggest that future real returns of only 4% are likely from ***high-risk*** portfolios.

Ray Dalio believes that the performance of such portfolios is unlikely to be repeated over the next decade, with which we largely agree. However, as we all know, timing such turning points is difficult if not impossible. Nonetheless, investors who believe that markets will continue to behave as they have over the last 10 years (and turn out to be correct) would be best served through SAA portfolios. Conversely, SAA portfolios are likely to perform poorly if markets experience high levels of turbulence that leads to an equity (and potentially bond) market sell-off. In this regard, SAA portfolios are exposed to significant drawdown risk, which may be acceptable to investors with very long-term investment horizons. However, aversion to drawdown risk for investors with shorter investment horizons who require regular income from their portfolios (and haven't got the luxury of waiting for markets to recover) – such as many baby boomers – is much greater. Such scenarios may significantly impair their financial well-being.

DYNAMIC ASSET ALLOCATION

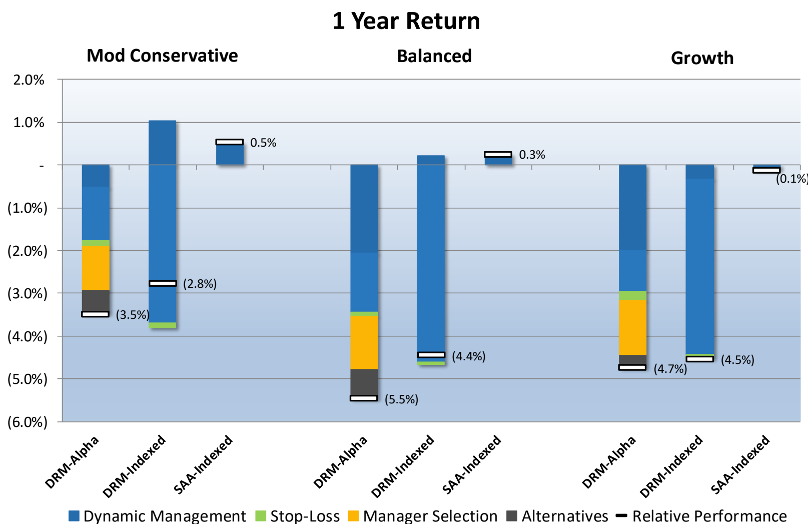
Dynamic Asset Allocation (DAA) approaches are generally more appropriate for investors that have higher sensitivity to drawdown risk. In contrast to SAA portfolios, which keeps the asset allocation constant (more or less) and permit portfolio risk to vary irrespective of changing market conditions, Dynamic Asset Allocation (DAA) seeks to add value through adjustments in the asset allocation.

Some DAA portfolios take the approach of investing in underpriced (cheap) assets and divesting from overpriced (expensive) assets. While this sounds like a prudent approach, it can often be prone to periods of underperformance when perceivably expensive markets continue to rally for several years (eg 1996-2000; 2005-2007; 2016-2019).

The DFS flagship Risk Profile Models (RPMs) apply a **Dynamic Risk Management (DRM)** approach. We believe it produces better portfolio outcomes compared to conventionally managed portfolios over the long term; and is more suitable for investors with greater sensitivity to drawdown risk. When material changes in market risks are observed and/or anticipated, we stabilise portfolio risk by changing the asset allocation. During periods of elevated risk, our primary default is to rotate assets to defensive investments such as bonds and cash. The converse occurs during periods when risks have abated. We also have a stop-loss mechanism that sells (or reduces) exposure to overvalued equity markets when support for that market breaks down.

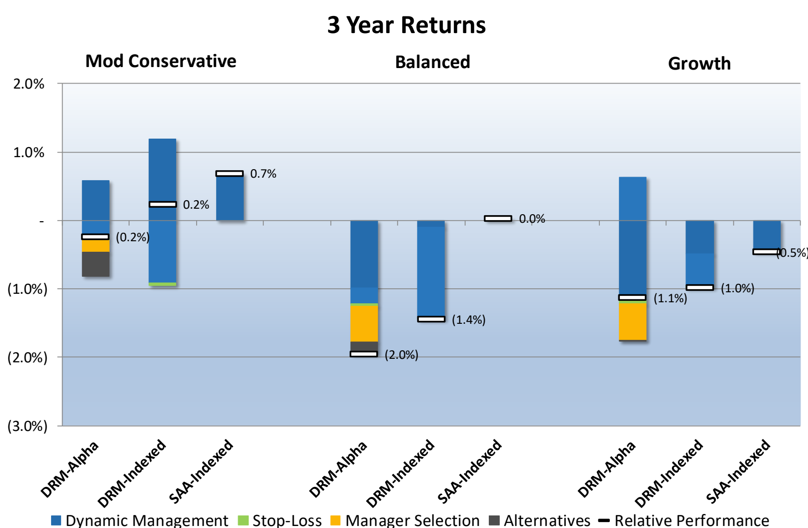
Over the last 12 months, our DRM Models have been underweight growth assets compared to their corresponding (SAA based) benchmarks. This reflects our portfolio risk concerns, which underpin the basis of our downside risk management. We believe an environment that is characterised by geopolitical tensions; trade wars; elevated equity market valuations; and a real possibility of

a meaningful global economic slowdown, with historically low bond yields (~$15 is trillion negative yielding) justifies our concern. Such concern is reflected through underweighting growth assets over the last 12 months across our DRM Models, which has led to meaningful underperformance, as highlighted in the chart below.

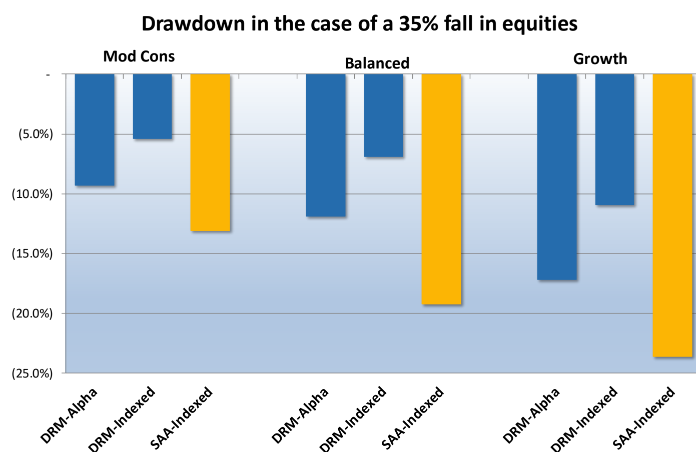


The above chart shows the 12-month excess returns of our SAA Models and DRM Models against their corresponding Morningstar benchmark. While the SAA-Models have performed in line with their benchmarks, the DRM Models have underperformed by between 2.8% and 5.5%.

The chart below shows the 3-Year returns of our SAA Models and DRM Models; and highlights more moderate levels of underperformance from DRM Models. Over the 3 years the extent of underperformance from the DRM Models ranges between 0.5% p.a. and 2% p.a. Most of the 3-Year underperformance is the product of the recent 12-month underperformance.



While any level of underperformance is displeasing, we highlight that that the DRM Models are being compared to SAA-based benchmarks over a period that strongly favoured SAA portfolios. We see a fuller picture by considering what would happen in troubled markets as well; for instance, how our DRM Models are expected to perform against SAA Models under a scenario of equity markets selling off by (say) 35%:



The above chart highlights that SAA Models are more exposed to drawdown risk compared to the DRM Models. The average drawdown on the SAA Models under this scenario is 19% (ranging b/w 13% for Mod Conservative and 24% for Growth), while the corresponding average for the DRM Models is 10% (ranging b/w 5% for Mod Conservative and 17% for Growth).

We further highlight the asymmetric effect of negative returns. For example, looking at the Balanced-SAA Model, it would need to generate a subsequent return of 23.9% to recover its expected drawdown of 19.3%. This highlights that underperformance during drawdown periods is more taxing on portfolios than corresponding underperformance in rising markets; and it highlights why downside risk management is generally more important to baby boomers.

Conclusion

Maximising returns when markets are buoyant is very important to investors as they are generally in an upward trend more than 70% of the time. In this regard, a good investment process needs to work during good times and bad. We note that the DFS DRM Models have largely kept up with the market for most of the time over the 7 years; however our recent de-risking has led to underperformance against their benchmarks. While underperformance over protracted periods can lead to high opportunity costs, it also needs to be balanced with downside risk management, particularly during periods where the potential for downside risk is heightened. We believe we are approaching such a "paradigm shift" which may have significant implications for many baby bombers. Our DRM Models are well positioned to respond positively and provide strong downside risk management.

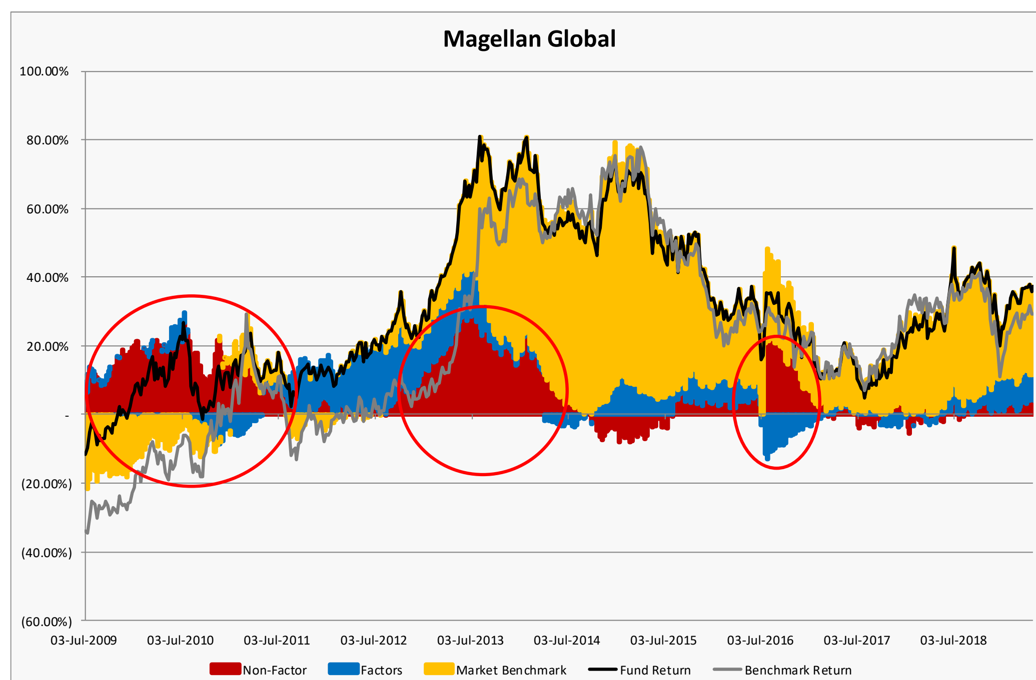
A FINAL WORD ON ACTIVE MANAGEMENT

The more astute readers (or those of you that have managed to get this far into the article) may have noticed that the DRM-Index Models offer greater downside risk management potential than the DRM-Alpha Models. The reason for this is that the Indexed Models are essentially made up of passive investments. When stop-losses are triggered on equity markets, it takes effect on the passive holdings. In contrast, the DRM-Alpha Models incorporate both passive and active managers; and it's only the passive holdings that are subject to the equity stop-loss mechanism. Divestment from equities when markets sell-off are thus shallower for the DRM-Alpha Models than the DRM-Indexed Models.

While the purpose of active managers within the DRM-Alpha Models is to generate outperformance over the full cycle, we anticipate that most of the outperformance will be realised during periods of heightened market turbulence. Active managers are interested in the relative value between companies, which can only be determined through (insightful) fundamental research. In practice, many active managers struggle to keep up with the market when conditions are buoyant as sentiment (or liquidity) rather than fundamentals largely drives such markets. When sentiment changes, fundamentals take over and this is where quality active management is expected to come to the fore.

The markets have overwhelmingly been driven by liquidity in recent years, over which time active managers have generally underperformed against their benchmarks. We highlight that these forces have been responsible for the underperformance of our DAA-Alpha Models versus the DRM-Indexed Models. However, we expect these forces will largely reverse under a (paradigm) shift in market conditions.

To illustrate the recent plight of active managers, we take a close look at one of Australia's best-known active managers, Magellan.



This chart decomposes Magellan's rolling 2-year returns (shown by the dark grey line) into three categories.

- **Returns due to exposure to the broader market**: these returns are much like those of an index fund and require no particular skill to generate.

- **Returns due to exposure to various style factors:** for instance, Quality, Momentum or Value stocks. These have been identified as potentially offering better returns over the long run, but different factors perform well at different times. There are indexed funds available to provide exposure to these style factors. They help reveal possible biases in a fund's investment strategy, but typically aren't a meaningful source of a manager's 'value add'.
- **Non-factor returns:** these are the returns due to a manager's active stock selection decisions. If a manager has genuine skill to beat the market, this is where we expect it to show up; and on which we are prepared to pay active fees. Positive non-factor returns mean that the decisions the manager makes have been rewarded.

Magellan's chart shows that in times past it has successfully beaten the market, often by a considerable margin. They did particularly well when the market was struggling – during the global financial crisis of 2008; coming out of Greece's sovereign debt crisis (2012) and the taper tantrum in 2015. Although the fund has shown an ability to beat the market when circumstances allowed, it's been three years now since Magellan produced any decent non-factor returns. Over that time, the market has been driven by liquidity rather than by fundamentals. The best Magellan could do in such periods was to keep up. Many active managers struggled to do even that.

Nonetheless, we believe that active management still serves an important purpose. The current environment has been unfavourable for active management because of the volume of money following liquidity rather than fundamentals. There's no telling just when that trend will break; but it will break. "Fundamentals" is just a big word for the best estimate of a security's future outcomes. When that future arrives, we can expect the money following the fundamentals to be rewarded and the money just following the other money to get punished. As we see in Magellan's case, this is when active managers add value to a portfolio. And the further the market strayed from fundamental value, the greater that value is likely to be.

A portfolio that includes active managers may well outperform over the long term. Importantly, the times when it outperforms are when it's most needed – when markets are losing value. Active managers can therefore form part of a disciplined approach to downside risk management.

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[i] Ray Dalio is an American billionaire investor, hedge fund manager, and philanthropist. Dalio is the founder of investment firm Bridgewater Associates, one of the world's largest hedge funds. Bloomberg ranked him as the world's 58th wealthiest person in June 2019.