THE EQUUS REPORT

—BY BARNABY LEVIN

Asset Allocation, Investment Strategy & the Power of Compounding

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When we discussed "**Risk** & **Reward**" in my last EQUUS Report, I said – what most people consider "**Low *Risk***" – no longer ***is*.** I suggested that – for those who say **mathematical formulas** (other than as a place to ***start***) can accurately ***"optimize"*** a Portfolio or tell us where best to invest – it may be a bit misleading (especially if they're using historical returns, over the past 15 years, as the basis for making their forecasts, no matter ***how*** many "Monte Carlo" iterations they run).

We (now) **know** that rules like "60/40" (certainly in a Low- or Zero-interest Rate World) not only fail to ***mitigate*** Risk – they often ***add*** to it.

And, in the end, I proposed (what I believe to be) a more helpful perspective – when it comes to analyzing one's ***tolerance*** for **Risk** – which is: to define (for yourself) what is "**Acceptable**" and "**UN-acceptable**," taking whatever **Time** you have to ***reach*** the outcome you hope to achieve, into consideration.

Given the above, I think (then) it makes sense to revisit two topics we haven't specifically focused on (in and of themselves) for some time, which is **Asset Allocation** and **Investment Strategy.**

Let's ***start*** (again) by defining what "Asset Allocation" ***is***.

Asset *Allocation* is the process one goes through – when seeking to balance a Portfolio's potential for "Risk" and "Reward" (that is, for Losses and Gains) – by adjusting the percent you invest in each asset or Asset Class, according to your Goals and Timeframe – and your ***Tolerance*** for "**Volatility**" (by which we mean one's financial and ***emotional*** ability to tolerate a **substantial *drop*** in **Value**). The Goal (again) is to balance whatever we have in our Portfolio – when choosing from all the ***many*** possibilities we have – under the ***assumption*** each asset will (theoretically) behave differently than the others, in different economic scenarios and circumstances.

Toward that end, people seek to ***diversify*** their holdings – to *reduce* their exposure to any *particular* asset**,** in case something unexpected or unforeseen happens, causing that investment to "implode" which, when it comes to achieving an acceptable return, could be disastrous. The purpose of "Diversification," then, is primarily to ***minimize*** the risk of catastrophic **LOSS**.

Strategically – after reserving for any short-term needs and some sort of buffer for emergencies – it's only then we recommend people turn to longer-term, lifestyle goals (including Retirement or Philanthropy) when targeting things like Growth and "Total Return" – by investing in stocks, bonds and real estate (for example) and, on an ongoing basis, re-assessing our investments – periodically adjusting the mix as Markets move and things change in our lives, to make sure we stay on track.

But in the process, it's important we be guided by some ***Philosophy***, like Stephen Covey does in his book, *The 7 Habits of Highly Effective People*, where we learn to "***Begin*** **with the *End* in Mind"** (that is, knowing **where** we want to ***go***).

In my ***opinion***, a person's Asset Allocation should boil down to three questions:

- What **concrete *Goals*** a person wants to Achieve;
- How much each of those Goals will "**cost**" (in terms of time, effort and money); and (most importantly)
- How much **Time** they have to **achieve** them.

If the Timeline is 1 year or less, the primary consideration should be "Preservation of Capital." If 10 years or more, it's to "Maximize Growth" – and everything in between is some blend of the two.

Another consideration I referred to earlier is something called "**Correlation**," which has to do with identifying investments we *expect* will behave *differently* from one *another*, under different circumstances. By now we know this isn't always the case – that (like we said in "**Risk & Reward**") in times of ***Crisis*, *all*** Asset Classes become **Correlated** (and go ***Down***). But we've found – in a Low- or *Zero* Interest Rate World – the way ***every***thing relates to everything ***else*** has changed. So, while we know (in general) it's important to Diversify to ***some*** degree – the ***real*** question is "**How Much**"?

One way in which I differ with ***most*** others is based on this notion – that if you ***knew*** a given investment would weather any storm and give you a ***fantastic***, long-term, rate of return, why wouldn't you put ***all*** your eggs in one basket or that **one** stock? ***That's***

how people like Bill Gates, Jeff Bezos and Elon Musk became ***wealthy*** – by (almost exclusively) owning a ***substantial*** amount of Microsoft, Amazon and Tesla (respectively) and holding onto them for (almost) ever, through all the Market ups and downs.

This is part of what's known as ***Compounding*** – which I discussed at length in my EQUUS report, titled "**The Pareto Principle**" and will soon offer other examples (with Laurie) in an upcoming Podcast called "**The Power of Compounding**."

One ***big*** difference, however – in answer to my question about single-stock concentration – is that each of ***these*** people owned and operated the companies themselves and, as **Founders**, had (again) a ***substantial*** amount of the company's outstanding shares. So ***they*** knew (better than anyone) exactly where they were going and how they planned to get there. ***They*** were in **control** and the ones making the **decisions** – how to **manage** their Company's **Balance** Sheet and which products or technology they were going to invest – where in ***our*** case, we're along for the "ride," with no meaningful say and just ***hoping*** for the best.

But ***another*** reason (we don't concentrate to ***this*** degree) is (of course) because we can never "know" (whether things will go according to "Plan" or not). ***Nobody*** has ***that*** good a "crystal ball." So we add some other things: some different stocks; perhaps precious metals; maybe (these days) some short-term or Floating-Rate bonds; and a few "alternatives," like a good Hedge- or Venture Capital Fund.

In my ***opinion***, though, it's better to have fewer baskets – and to watch those baskets more closely – because (as I've said) I believe in **concentration**; the **power** of ***compounding*;** and on ***focus***. And, like Warren Buffett (assuming you ***truly*** did your **Due Diligence** ***ahead*** of time) letting your **Winners** ***run*** unless something ***dramatic*** changes and, in the process, alters the reason you made the purchase in the first place.

When it comes to **Expected Rates** of **Return**, most Advisors will (again) tell you there's no way for anyone to "***know*** the **future**" – so it's better to simply "hedge" your bets by investing across *all* Asset Classes. I understand and, to some degree, agree. I (full-heartedly) believe one must take (not only the current, Economic Environment into account) but also think in terms of moving a football down the field (and of one's "**field *position***" at any given time). With the Yield on 10-year *Treasuries* (for example) just under 4% -- in the face of rising interest rates and inflation – I'd still argue (when it comes to bonds) we're on the 80 or 90-yard line, with very little upside (versus the downside Risk) should rates ***continue*** to rise.

I ***will*** note (according to the Chartered Alternative Investment Association),[1] that 20***22*** was the **first time** Equity ***and*** Fixed Income fell simultaneously, to such a degree. Perhaps that was because equities ***started*** the year at an all-time **high** and ***yields*** at an all-time **low**. ***Perhaps*** (like the old man says in Monty Python's "**Meaning of Life,**" while they're carrying him away, against his wishes), the "old" **60/40** mix isn't "***quite*** dead yet"...

But I've believed for some time that – ***regardless*** of age – ***any*** allocation to bonds needed to be smaller and of shorter duration than at any time over the past forty years. It wasn't an easy decision (to leave behind the supposed "safety" of bonds) some years ago – nor is that decision "***forever***." But when things ***change***, **so** must ***we*** and – with rates at or near zero – it simply didn't make sense to invest in something whose primary goal was "Preservation of Capital" when I ***knew*** (virtually) ***anything*** could cause rates to **rise** and (in inverse fashion) the **value** of our bonds to ***fall***, like they did (more than 31%)[2] last year.

Also, when it comes to things like "**Valuation**," there is no "right" or "wrong." Many people feel that (by almost ***any*** measure) stocks are **stretched** and (perhaps) people's expectations are (once more) too optimistic. I'm more in the "**Growth at a Reasonable Price**" (or "**GARP**") Camp, but there are lots of successful folks who believe in the teachings of Benjamin Graham, with a keen focus on what we call "**Value**." They think (for example) – when a company's assets are trading at or below "**Book Value**" (that is, when it's cheaper to buy than build) – ***that's*** when you want to invest (which is where the saying "**Buy Low, Sell High**" came from). ***Sometimes***, it's better to sit on the Sidelines, if you can't find anything worthwhile to buy – for whatever ***you*** consider a "**reasonable**" price, given the methodology ***you*** use. But it may ***also*** mean you just invest ***less*** (in that particular stock) and have lower expectations because – given where rates are today, when you take dividends into consideration – there's a decent number of companies (despite valuation) whose stock should do better than bonds, when thinking ***long*** term.

[1] "6040s Annus Horribilis," caia.org/blog/2023
[2] The Bloomberg Barclays Aggregate Bond Index

But what ***is*** "**Valuation**"? Besides (that is) whatever **price *someone***'s willing to pay – or the ***yield*** they're willing to accept? In ***Europe*** (over the years since Mario Draghi, as President of the ***EU***'s Central Bank, famously said he'd "**do** whatever it ***takes***" to save the Euro, in 2013), they ultimately raised more than $17 ***Trillion*** in debt with a ***negative*** Yield-to-Maturity. **That** means a ***lot*** of "investors" were willing to ***pay*** someone for the "privilege" of lending them ***their*** money (instead of the other way around), when it's the ***Lender*** who's taking all the risk and ***should*** be the one getting a return. Perhaps they believed things would get even ***worse*** – but $17,***000,000,000,000*** worth?

In ***general*** (however), Valuation is **supposed** to be based on some *estimated*, **Future Cash Flow**, *relative* to something called the "**Risk-Free Rate of Return"** of a 1 (or 10) year Treasury – and people (then) try to discount that back to find "Fair Value" today.

Yet, given where things stand – with interest rates still as low as they are – determining "Fair Value" is more challenging to assess and I tend to think more in terms of **Leadership**; a company's **Total *Addressable*** Market (or "TAM"); and **Market Share** – and on their long-term **Product Roadmap**, so we can see where they're going and what ***other*** levers they have to pull when one of their "shots" (ultimately) doesn't work out as planned.

Finally, on the topic of **Compounding**, the image I like best is "**The Snowball Effect**" – when someone pushes a hand-sized ball of snow down a hill and, as it rolls, it continues to pick up more snow along the way – adding more and more the bigger it gets, with each revolution – until it grows to the size of a boulder by the time it reaches the bottom. This (again) explains why the smallest of actions, carried out over and over, over time, can lead to ***big* results**, which is the "***magic***" of **compounding**.

As you know, **Warren Buffett** is one of the people I like most to quote – and I'm sure he'd be the first to admit he's made **more** than his share of **mistakes**, over the years. But when he gets it ***right*** – because he and Charlie Munger let them run, like they've done with Apple (which, as of last year, grew to 41% of their Portfolio)[3] – it more than made up for all of them (and is why, in 1997 in his Berkshire Hathaway Letter to Share-holders, he said "We continue to make more money when snoring than when active."[4]

[3] "Top 5 Positions in Warren Buffett's Portfolio" by Richard Best, Investopedia, May 19, 2022
[4] Berkshire Hathaway's "1996 Letter to Shareholders," published by Warren Buffett, February 28, 1997

After a lifetime of looking, he and Charlie have only found a handful of (what they call) "**Inevitables**" so, when ***you*** find one (they say), "An investor should act as though he had a lifetime decision card with just twenty punches in it. With every investment decision, his card is punched and he has one fewer, for the rest of his life." In other words, these "Inevitables" don't come along every day so (for gods' sake!) don't let it ***go*** (unless you absolutely "**have**" to or the company r***eally*** screws up and there's ***nothing*** Management can do to get them back on track).

So, to summarize:

- Given where rates are (in the ***low*** single digits), we ***still*** feel there should be a ***smaller* allocation** to **Bonds** than traditional Age-based, "60/40" Models suggest;
- While it may (sometimes) temper short-term gains in a ***Bull*** Market, there **are** ***other*** Asset Classes (like these things called "***Alternatives***") that can help offset ***downside* risk** in a person's Portfolio (***if*** they qualify) and are willing and **able** to sacrifice some liquidity;
- Based on today's low interest rates and *elevated* valuations, we think one's Expectations for Returns should be somewhat more tempered for the foreseeable future; and
- Depending on one's Stage in Life, it's as important as ever to add to ones' investments – on a consistent and ongoing basis – not only to increase Savings but (given the higher Volatility) take ***advantage*** of those inevitable swings, when others are fearful.

"**Make a Plan; Work a Plan**," I like to say – to be ***sure*** you're always in the right frame of mind – so you can ***resist*** the ***temptation*** to give in to **fear** or short-term concerns. It's ***not*** that you should ***ignore*** important **warnings** – whether of **"Detours Ahead"** (or a ***Cliff***) – in the belief things ***always*** go up. ***Clearly***, they ***don't***. And for ***those*** times (again), we want to make sure we ***always*** have plenty of money – in Reserve – so you're **never** forced to sell. And if and when the Market ***does*** take a downturn, make sure you're **not** on ***Margin***, which would (all-but) "guarantee" your Portfolio will fall, like a hot knife through butter.

The **Bottom Line** is, it's important to stay focused, at all times, on the **reasons** you're investing in ***any***thing (whether a stock; bond; ***or*** piece of real estate) and (at any given time) – if those reasons still hold true – don't let yourself be shaken out. We ***always*** want to be ***prepared*** (**emotionally *and* monetarily**) to take ***advantage*** of other people's short-sightedness, with ***some*** of those **Reserves** we raise when times are ***good***, even when (at times) it feels ***most*** uncomfortable.

Barnaby Levin
Partner | Managing Director | HighTower Advisors
LK Wealth & Asset Management