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June 2019 Edition

One year ago we examined the presumption of complacency in financial markets. "When good times roll, investors often exhibit FOMO[1] even if they overcome their cognitive biases; this leads to excessive risk taking and misallocated capital despite being aware of their shortfalls."[2] We question what if any behavioural shift has occurred over the past year.

"Those who cannot remember the past are condemned to repeat it."

George Santayana, writer and philosopher (1863-1952)

From 1990 to 2019 a balanced portfolio (60% global equity and 40% global fixed income) rebalanced annually has returned 592% or 6.8% per annum with a variance of 99.8 per annum. The equity component has contributed 69% of this return while exhibiting 85.7 per annum variance over the period (compared to fixed income which has a 3.8 variance (4% of total).[3] At the end of the period (April 30, 2019) that balanced portfolio has a 63:37 asset (risk) allocation consistent with the original objective in 1990.

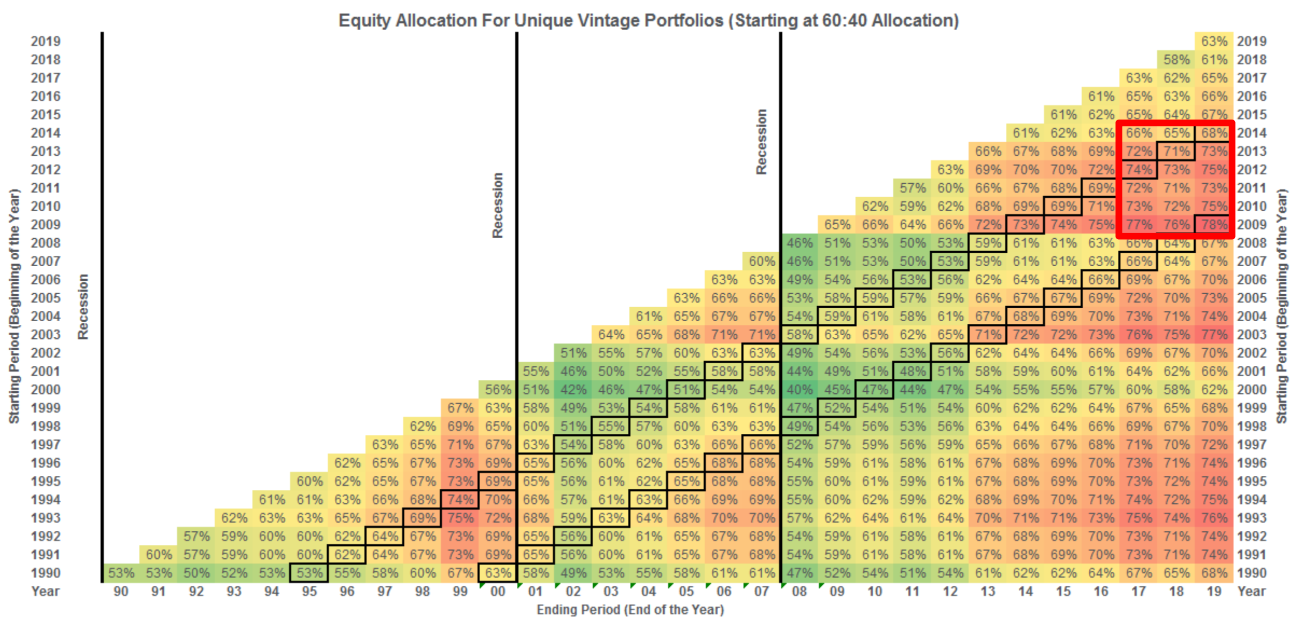
History has repeatedly told us to rebalance periodically in order to take advantage of the different risk/return attributes of equities and fixed income through different market cycles. Put simply: to never rebalance is to compromise returns.

We worry that a goldilocks macro environment can lull complacent investors into a let it ride investment style. It is well understood that without rebalancing, higher equity returns will over time create over allocation to risk relative to the original objective. A 2009 vintage balanced portfolio has returned 8.8% (per annum) through April 2019; the equity return contribution (91% of total) would create a 78:22 risk allocation – a sharp divergence from the original.

Rebalance Frequency	Total Return
Yearly	592%
Biennially	576%
Quinquennially	585%
Decennially	582%
Never	523%

The chart below shows the impact on asset allocation from returns for different vintages dating back to 1990. The areas outlined in black show five and ten year returns for their respective vintage portfolios. As you can see in the bottom right hand corner of the red highlighted box the areas in red showcase over allocation to equity risk as a result of returns over time – this trend has preceded economic recessions before.

We see a dangerous spike in over exposure for such portfolios today and caution investors not to lose their balance.



[1] Fear Of Missing Out
[2] GIB (UK) – June 2018 Edition
3 A portion of the portfolio variance is interlinked due to correlation effects and therefore cannot be split out. Balanced portfolio variance was 99.8 which consisted of 85.7 from equity, 3.8 from fixed income, and 10.3 from the equity/fixed income relationship.

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Equity Allocation For Unique Vintage Portfolios (Starting at 60:40 Allocation)

Starting Period (Beginning of the Year) / Ending Period (End of the Year) — Recession marked at 90, 00/01 and 07/08

Year	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14	15	16	17	18	19	Year
2019																														63%	2019
2018																													58%	61%	2018
2017																												63%	62%	65%	2017
2016																											61%	65%	63%	66%	2016
2015																										61%	62%	65%	64%	67%	2015
2014																									61%	62%	63%	66%	65%	68%	2014
2013																								66%	67%	68%	69%	72%	71%	73%	2013
2012																							63%	69%	70%	70%	72%	74%	73%	75%	2012
2011																						57%	60%	66%	67%	68%	69%	72%	71%	73%	2011
2010																					62%	59%	62%	68%	69%	69%	71%	73%	72%	75%	2010
2009																				65%	66%	64%	66%	72%	73%	74%	75%	77%	76%	78%	2009
2008																			46%	51%	53%	50%	53%	59%	61%	61%	63%	66%	64%	67%	2008
2007																		60%	46%	51%	53%	50%	53%	59%	61%	61%	63%	66%	64%	67%	2007
2006																	63%	63%	49%	54%	56%	53%	56%	62%	64%	64%	66%	69%	67%	70%	2006
2005																63%	66%	66%	53%	58%	59%	57%	59%	66%	67%	67%	69%	72%	70%	73%	2005
2004															61%	65%	67%	67%	54%	59%	61%	58%	61%	67%	68%	69%	70%	73%	71%	74%	2004
2003														64%	65%	68%	71%	71%	58%	63%	65%	62%	65%	71%	72%	72%	73%	76%	75%	77%	2003
2002													51%	55%	57%	60%	63%	63%	49%	54%	56%	53%	56%	62%	64%	64%	66%	69%	67%	70%	2002
2001												55%	46%	50%	52%	55%	58%	58%	44%	49%	51%	48%	51%	58%	59%	60%	61%	64%	62%	66%	2001
2000											56%	51%	42%	46%	47%	51%	54%	54%	40%	45%	47%	44%	47%	54%	55%	55%	57%	60%	58%	62%	2000
1999										67%	63%	58%	49%	53%	54%	58%	61%	61%	47%	52%	54%	51%	54%	60%	62%	62%	64%	67%	65%	68%	1999
1998									62%	69%	65%	60%	51%	55%	57%	60%	63%	63%	49%	54%	56%	53%	56%	63%	64%	64%	66%	69%	67%	70%	1998
1997								63%	65%	71%	67%	63%	54%	58%	60%	63%	66%	66%	52%	57%	59%	56%	59%	65%	66%	67%	68%	71%	70%	72%	1997
1996							62%	65%	67%	73%	69%	65%	56%	60%	62%	65%	68%	68%	54%	59%	61%	58%	61%	67%	68%	69%	70%	73%	71%	74%	1996
1995						60%	62%	65%	67%	73%	69%	65%	56%	61%	62%	65%	68%	68%	55%	60%	61%	59%	61%	67%	68%	69%	70%	73%	72%	74%	1995
1994					61%	61%	63%	66%	68%	74%	70%	66%	57%	61%	63%	66%	69%	69%	55%	60%	62%	59%	62%	68%	69%	70%	71%	74%	72%	75%	1994
1993				62%	63%	63%	65%	67%	69%	75%	72%	68%	59%	63%	64%	68%	70%	70%	57%	62%	64%	61%	64%	70%	71%	71%	73%	75%	74%	76%	1993
1992			57%	59%	60%	60%	62%	64%	67%	73%	69%	65%	56%	60%	61%	65%	67%	68%	54%	59%	61%	58%	61%	67%	68%	69%	70%	73%	71%	74%	1992
1991		60%	57%	59%	60%	60%	62%	64%	67%	73%	69%	65%	56%	60%	61%	65%	67%	68%	54%	59%	61%	58%	61%	67%	68%	69%	70%	73%	71%	74%	1991
1990	53%	53%	50%	52%	53%	53%	55%	58%	60%	67%	63%	58%	49%	53%	55%	58%	61%	61%	47%	52%	54%	51%	54%	61%	62%	62%	64%	67%	65%	68%	1990

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