IMCO Investment Management Corporation of Ontario

OCTOBER 2022

DON'T HIT THE PANIC BUTTON:

How investors can manage (and even profit from) short-term market volatility

Bert Clark,
President & CEO, IMCO

Rossitsa Stoyanova,
Chief Investment Officer, IMCO

HOW WE THINK AT IMCO

At IMCO we believe that short-term volatility of returns is generally unavoidable for long-term investors. We think the key is not to try to alter asset mix to avoid it, but to have adequate liquidity to survive and, in some cases, profit from it.

In retrospect, "down markets" may seem predictable and can cause investors to wonder whether they should stick with their long-term asset mix. Hindsight is 20-20, as they say. However, as painful as these periods of underperformance feel, we believe that investors should not attempt to tactically adjust their asset mix to avoid short-term weakness in returns. Instead, our view is that investors should stick to their long-term asset mix and seek high quality, long-term investment opportunities during times of market stress.

The following sets out our approach to responding to short-term market events.

2022 CONTEXT

2022 has been one of the most challenging years for most investors. All public assets have been repriced as central banks have begun to withdraw liquidity and raise interest rates in their efforts to combat multi-decade, high levels of inflation. No long-term asset mix has been immune to the repricing impact of central bank activity in 2022. Consider that a traditional portfolio with a 60/40 mix of stocks and bonds would have generated returns of negative 11 percent, while typical LDI (liability-driven investment) and risk-parity portfolios would have generated returns of negative 17 percent.

In general, portfolios that performed well in 2022 (so far) are those dominated by private assets, where valuations are lagged. To avoid losses, investors in public assets would need to have taken dramatic action at the beginning of the year, such as selling most of their assets and sitting in cash. This type of tactical adjustment in asset mix is not realistic (or advisable) for most investors.

A RANGE OF MODELS FOR LONG-TERM INVESTING

Very broadly speaking, institutional investors tend to pursue long-term investment strategies that are based on one of four basic models:

1. **Growth Oriented Asset Mix:** The 60/40 asset mix, as well as other asset mixes dominated by asset classes subject to significant short-term volatility, fall into this category. The main idea underlying these asset mixes is that over the long-term, investors are rewarded for owning assets like equity, credit, infrastructure, and real estate notwithstanding the volatility of their returns in the short-term.

   One of the greatest risks of this portfolio strategy is inadequate liquidity which can force asset sales at market lows. Long-term growth-oriented investors need to manage their liquidity. The other major risk this strategy faces are periods of sustained weak performance in growth-oriented assets, which can occur. For instance, over the last 90 years, equity markets have outperformed bonds in 9 of 10 rolling 20-year periods. Betting on growth has a good chance of succeeding over the long-term, but it does not guarantee success.

2. **Liability Driven Investing (LDI) Oriented Asset Mix:** LDI investors select assets that are closely tied to the liability they are trying to meet. Often, this is assumed to be long-term bonds because this is what actuaries use to discount certain liabilities. Because the return on these assets is often relatively low, relative to the returns required to meet the liability, investors typically need to use significant amounts of short-term borrowing to increase their total portfolio returns.

   The biggest risk of this strategy is operational implementation because prudently employing large amounts of leverage is not something many firms can do. Another risk is that actual liabilities and investments are different from the asset being used to discount liabilities driven by circumstances like changes in longevity and central bank intervention in the markets.

3. **Risk-parity Asset Mix:** The primary objective of risk parity is to invest in a range of assets (including growth-oriented assets like equities and credit as well as bonds, and commodities) so that the total portfolio performs well in a range of macro-economic environments (e.g., growth with high/low inflation and economic contraction with high/low inflation). If the returns of this asset mix are too low to meet an investor's return objectives, because of large allocation to bonds and commodities, short-term borrowing is used to increase returns.

   One of the risks of this model is the operational risk associated with significant use of leverage. Additionally, there is a risk that the actual correlation among risk-oriented assets, bonds, and commodities do not match the model and the portfolio performs well under a narrower range of macro-environments.

4. **Reserve Fund:** The basic idea is to invest in assets that are readily available to meet unforeseen needs. Such funds tend to be invested in shorter-term, lower risk assets to avoid having to sell volatile assets at the wrong time.

At IMCO our clients generally have either growth-oriented or reserve fund type asset mixes.

WHY WE ARE COMMITTED TO OUR CLIENTS' LONG-TERM ASSET MIX, DESPITE SHORT-TERM MARKET EVENTS

Systematically managing asset mix is a superior strategy for most investors and this is the approach we take. Once we have worked with clients to help them select a long-term asset mix, we don't believe in materially adjusting the mix in the short-term to try to navigate short-term market events.

There are investors who have demonstrated the ability to reliably alter asset mix to anticipate and successfully navigate market events. However, the number of such successful investors is small. These investors must accurately predict market events (before the market) and then adjust their asset mix to a sufficient extent to reap benefits. Assuming they have a long-term asset mix, they then need to correctly time the adjustment of their portfolio back to the long-term mix. This series of tactical adjustments is very hard to time and size correctly, and the consequences of getting these sorts of decisions wrong has the potential to outweigh many, if not all, other return enhancing activities.

HOW WE NAVIGATE SHORT-TERM MARKET EVENTS

Instead of trying to materially alter asset mix to navigate short-term market events, we pursue several strategies to reduce risk and enhance returns.

First, we systematically rebalance. Thankfully, most years are not like 2022 where all public asset classes have repriced downwards. Typically, because most asset classes do not rise and fall in unison (they are not all perfectly correlated) there is an opportunity to systematically "buy low and sell high" simply by regularly selling those asset classes that have risen in value and buying those asset classes that have fallen in value, so that the asset mix returns to the long-term target; this is called rebalancing.

While rebalancing is very effective at capturing opportunities and maintaining a fairly constant level of overall risk, it is not a strategy to deploy excessively. Even for non-taxable investors there are associated transaction costs. Moreover, rebalancing less frequently allows investors to benefit from the long-term tendency of growth-oriented assets to rise in value, without harvesting that increase in value too frequently.

Second, we explore buying opportunities within asset classes that are created during periods of short-term market turbulence. These opportunities can be pursued systematically in the same way as rebalancing (e.g., where certain market segments have been impacted disproportionately by market events, such as the private versus public or the high yield versus investment grade credit markets).

Periods of short-term market turbulence can also create individual investment opportunities (e.g., long-term quality company stocks can suffer declines in price, along with the broader market, which do not reflect their relative long-term value). Therefore, we seek to enhance returns during periods of market stress by pursuing both systematic and individual investment opportunities.

The last three years have reminded investors how much can change in a very short period. We have gone from a world in which investors worried about lower-for-longer deflation to a world of multi-decade high levels of inflation. Revisiting asset mix and asset mix transition plans annually allows investors to review and update their approaches to reflect changes in long-term return and correlation projections as well as long-term trends, changes in client risk tolerances, new products, investment capabilities or strategies. In most years, these changes should not be significant. But it is prudent to pause annually and, at a minimum, reconfirm the long-term plan.

SUMMARY: STAYING THE COURSE AND BEING OPPORTUNISTIC

Periods of short-term volatility are inevitable for long-term investors. At IMCO, we believe that sticking with our long-term asset mix (versus tactically adjusting it to avoid short-term market events) is the best approach. We also recognize that there are a number of investment strategies that can be used to profit from such periods, which include a mix of systematic techniques like rebalancing at the total portfolio and asset class level, as well as pursuing a bottom-up fundamental investment approach to enhance long-term returns.