Labs: Portfolio Diagnostics Services

PORTFOLIO DIAGNOSTICS REPORT

Uncertainty is not Unusual:

Maintaining a Long-Term Perspective During Short-Term Market Events

Five years ago, at the end of 2012, investors warily eyed the S&P 500® as it finished the year up 16%. This was its third year of double-digit returns since the Global Financial Crisis, and most U.S. equity investors were back in the black and fully recovered from 2008 losses. Attention turned to volatility in Washington, the main source of which was the ongoing debt ceiling debacle. It felt like a rational time for many investors to take profits and de-risk – in a sense, following the wise words of longtime financial writer Ray DeVoe:

> "More money has been lost reaching for yield than at the point of a gun."
> **Ray DeVoe**

We now know that the good times were far from over and the S&P 500® has since climbed roughly another 80%. As it turns out, in these unprecedented markets, investors have been better suited to follow the wise words of another financial mind, Peter Lynch:

> "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."
> **Peter Lynch**

If the past is any guide, today's uncertain markets are not unusual. In a global investment landscape full of opportunities and threats, we believe a broad global exposure is the best way to capitalize on the former while mitigating the latter. On the Janus Henderson Portfolio Construction Services team, we have partnered with thousands of advisors as they have navigated the recent past and worked to grow their clients' wealth in the face of all this uncertainty.

Warning: Bumps Always Ahead

On the Portfolio Construction Services Team, we consider a broad, balanced approach to be the essence of a good strategic asset allocation. As we consult with advisors on all aspects of their portfolios, this strategic perspective is not aimed at always being right – e.g., staying on the sidelines with Ray versus being all-in with Peter – it's aimed simply at not being wrong.

The essence of this approach is for Advisors to build their clients a broad, balanced portfolio that is both dynamic and tailored to their individual risk and suitability requirements. To then grow clients' wealth over the long run, history has taught us it's important to keep them invested throughout all market cycles. To manage short-term opportunities and threats throughout these long term cycles, Advisors can delegate this tactical component largely to active fund managers.

Fortunately for advisors looking to stay invested, there is no shortage of ammunition to prove this time-tested approach to their clients.

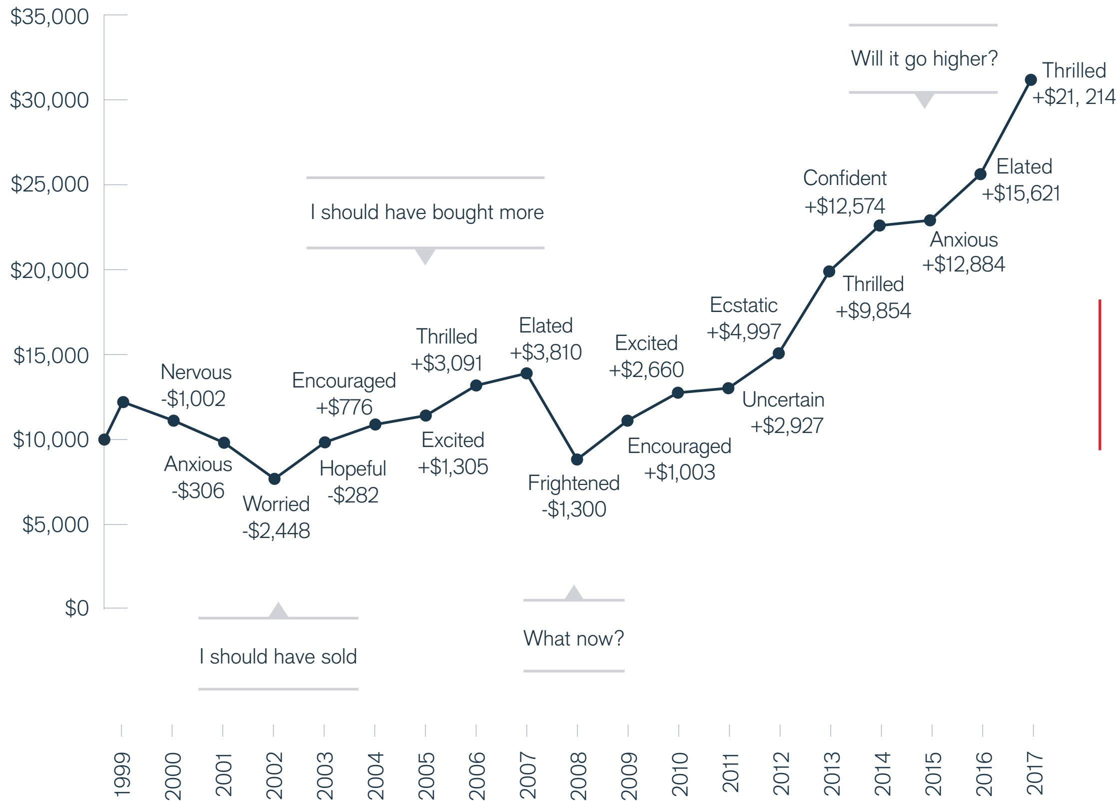
Uncertainty is not Unusual

Are We Elated, or Merely Ecstatic?

Since the turn of the tech bubble in the late 1990s, long-term U.S. equity investors have experienced massive gains, but only after cycling through an emotional roller coaster for the better part of 20 years:

Emotional Cycles of Investing in the U.S. Equity Market

The change in value of a hypothetical $10,000 investment in the S&P 500® Index (1999 – 2017)



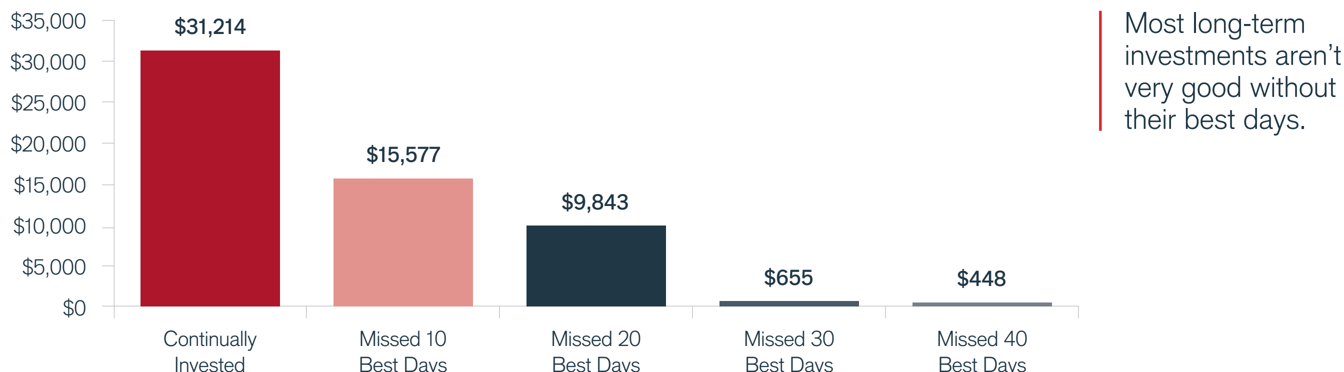
Selling when merely ecstatic in 2012 would have cost over $15,000 in future gains made through 2017.

For clients riding the ups and downs of equity investing, advisors often play the role of seat belt and harness – adding value by helping investors stay invested, whether those investors recognize it or not. Emotions are subjective by nature and an advisor often protects clients' timing impulses with an objective layer of reason and expertise.

Enjoy the Ride

When it comes to helping clients meet their investment goals, advisors can add value to long-term portfolios by not only minimizing unnecessary risks but also helping capture necessary gains over time. Drawdowns are obviously a major risk in equity investing, but another major risk for equity investors is the opposite: missing the run-ups. While the first illustration of long-term U.S. growth is ubiquitous, the role of buying and holding along the way deserves more attention:

Value of a Hypothetical $10,000 Investment in the S&P 500® Index from 1999 – 2017



Most long-term investments aren't very good without their best days.

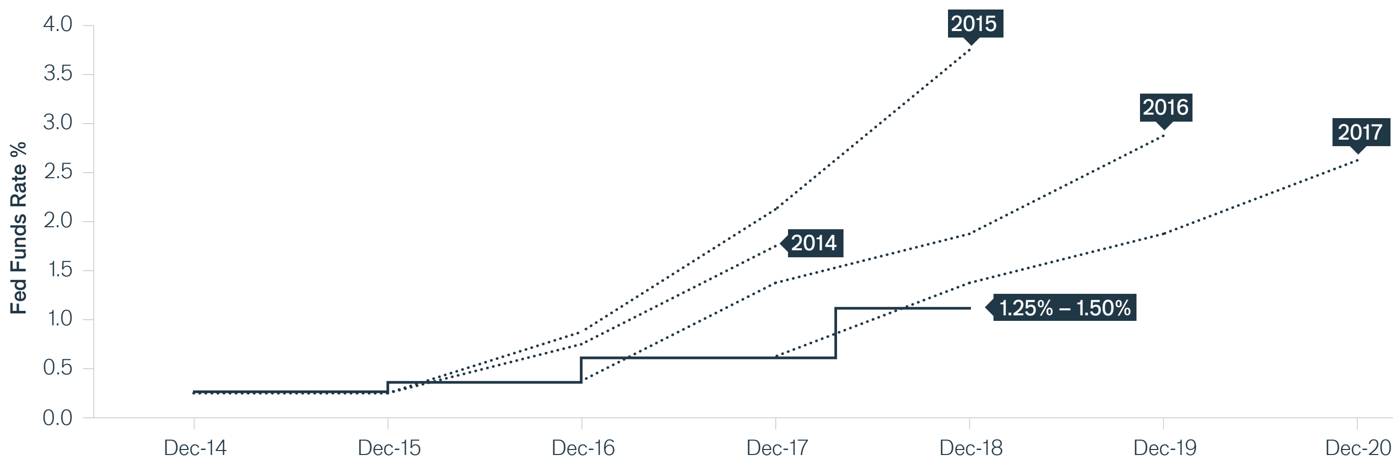
Source: FactSet Research Systems, Inc., data from 1/1/99 to 12/31/17.

Forecast Clients' Needs, not the Markets

On the note of client suitability requirements and broader portfolio risk management, even fixed income no longer offers a reprieve from today's broader market uncertainty. U.S. rates have hovered near historical lows at an absolute level, but, relative to the rest of the world, the U.S. is perceived to have some of the highest yields available. It's no wonder that forecasts have had little success in projecting the path of future interest rates:

The Path of U.S. Rates: A Perplexing Prognostication

U.S. Federal Funds Rate Projections vs. Reality



Source: Federal Monetary Policy Reports 2014, 2015, 2016, 2017

Uncertainty is not Unusual

In the frenzy of avoiding potential bond price losses that could accompany rising rates, many investors have become fixated on the direction of rates as a primary predictor of success in bond investments. As investors continue to debate the "if, when, how, and how fast" of interest rate changes, a crucial element is often missing from discussions: the importance of time horizon.

Even in a fairly pessimistic scenario for interest-rate-sensitive fixed income, the ability to stay invested might allow an investor to withstand moderate short-term losses and obtain bigger long-term gains.

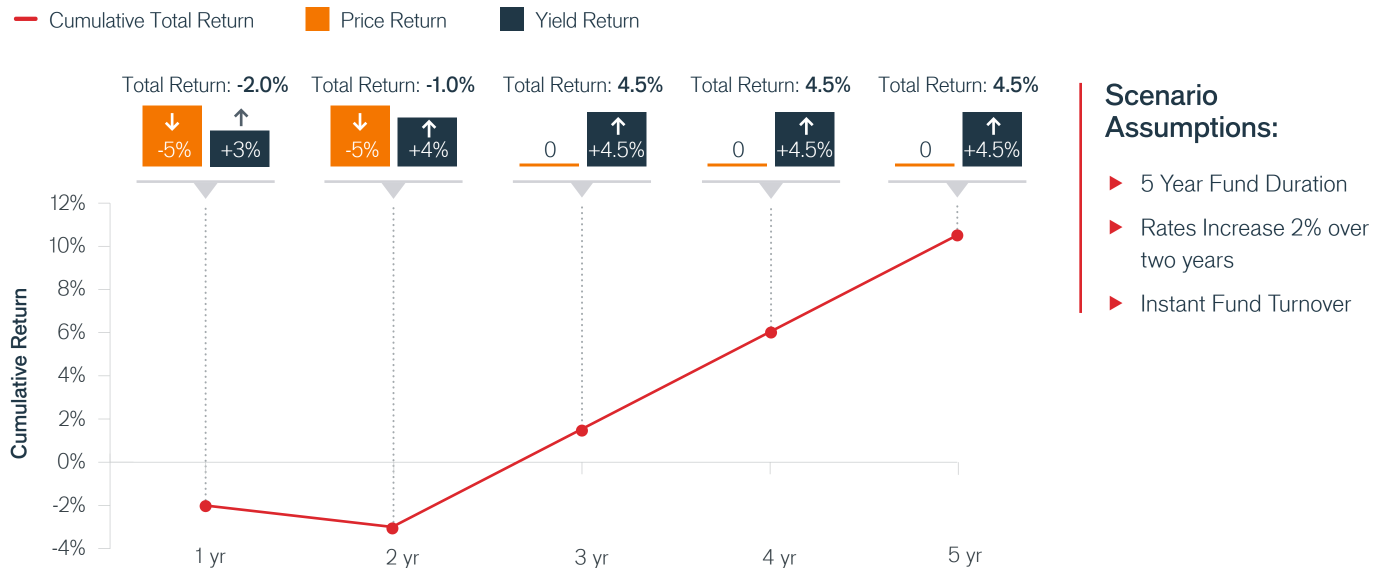
What is the Danger of Rising Rates?

Let's start with a hypothetical "intermediate bond" fund with a five-year duration, and assume that today's yield on the fund is 2.5%. Let's also assume in this scenario that rates increase 2% in parallel over the course of two years, a relatively aggressive path, and all other factors are constant.

On the one hand, this simple scenario confirms bond market fears by creating negative total returns for two years. On the other hand, returns turn positive by year three. In fact, now benefiting from 4.5% market rates, cumulative total returns reach 6% by year four and over 10% by year five.

The Rising Rates Scenario

Higher income buffers initial price declines and results in higher total return over time



Scenario Assumptions:

- 5 Year Fund Duration
- Rates Increase 2% over two years
- Instant Fund Turnover

While interest rate changes do matter, this market cycle has shown that projecting interest rate changes is a fickle business. More importantly, the projected losses in most rising rate scenarios may not be as alarming as some assume. Relative to other asset classes with a history of large double-digit drawdowns, most potential losses in core fixed income pale in comparison.

We believe clients are much better served with a goal-based approach, in which the level of duration in a portfolio is representative of a specified investment time horizon. Be careful not to let rate discussions and predictions sideline your focus on your clients' needs and key risks, which should be the main inputs to making a suitable asset allocation.

On Staying Invested

Among the uncertainty across global markets, market timing risk is one uncertainty that advisors can help control. It is in these uncertain markets that active fund managers allow advisors access to higher-conviction positions through a selective approach to identifying innovative, well-managed investments. This delegation allows advisors to help their clients stay their strategic course, while delegating the tactical component in order to overweight the potential winners of tomorrow rather than chase historical returns.

When it comes to helping clients reach their wealth goals, a long-term investment process is proven ballast for any historical storm. Now is the time for advisors to leave the timing element to the active fund managers and guide their clients to stay strategic in a portfolio that is tailored to their individual risk and suitability requirements.

For more tips on building better portfolios, visit our Portfolio Construction Services resources.

About Janus Henderson's Portfolio Construction Services Team

The PCS Team performs customized analyses on advisor portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of thousands of models emerge trends, themes and potential opportunities in portfolio construction that we believe will be interesting and beneficial to any investor.

For more information, please visit **janushenderson.com.**

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—KNOWLEDGE. SHARED—

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Hypothetical examples are for illustrative purposes only and do not represent the returns of any particular investment.

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