Anchoring Your Portfolio During Market Storms

"Stocks Plummet, Treasury Bonds Surge." Sound familiar? This is a typical headline these days as the new coronavirus (COVID-19) goes on a world tour. Stocks and bonds moving in totally opposite directions is often what happens when there is a market scare: "Risk-on" assets such as stocks and junk bonds suddenly become wallflowers, as Treasuries backed by the full faith and credit of the US government turn into belles of the ball.

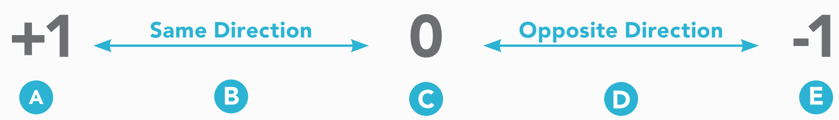
The high level of volatility in the US stock market is concerning. But it need not be devastating if you have a well-diversified portfolio that can handle a fair amount of turbulence. While some of your investments are hurting, others can be doing quite well. This divergence in fortunes helps to provide assurance, reduce risk, and smooth out cash flow. And all this makes it more likely you will stay invested through market drops so you can benefit from the eventual rebound.

THE PROBLEM: diversification is often ignored when the stock market is hitting new highs, as it has been for the most part of a decade. "Go Ahead, Put Your Eggs in One Basket," read a Wall Street Journal headline in January 2020, referring to the great strengths of the US stock market. There is no doubt that the US equity market will continue to be home to world-leading companies. A month after this headline, however, US equities suffered their fastest correction on record (drop of more than 10% in one week). In the near term, lots can happen. And it did, as COVID-19 has swept fear into the markets.

What Diversification Really Looks Like

Here at LNWM, we try as much as possible to create truly diversified portfolios by including a wide variety of investments, including a sizable allocation to high-quality government and corporate debt. How do we gauge diversification? A major consideration is correlation, which is the extent to which two assets' returns are aligned. The diagram below shows general levels of correlation. Assets whose correlations are less than +1 enhance portfolio diversification; the mathematical proof was provided by the Nobel Prize-winning economist Harry Markowitz.

Correlation Levels



What This Indicates

A. Total returns move in lock step in the same direction
B. Returns are aligned to varying degrees
C. No linear relationship in returns
D. Returns move in opposite direction to varying degrees
E. Returns move in lock step in the opposite direction

We view portfolio construction as a balancing act between risk and return, with the level of correlation among investments as the fulcrum. Let's take high-quality bonds as an example.

Bonds Away! But in Moderation

Please take a look at the chart below. It shows the correlation in returns between high-quality US bonds and all other asset classes during the past 10 years: from March 1, 2010 through Feb. 29, 2020. At top, you can see that the correlation of US high-quality bonds to themselves is 1.0 – perfect correlation, as of course you would expect. And the correlation to US Treasury bonds is also close to 1, as you would expect. But then things start to get really interesting.

The correlation between high-quality US bonds and US stocks (both large and small) is negative, less than zero. Historically, high-quality bonds have had the lowest correlation to stocks outside of cash. This is the main reason that high-quality bonds are great diversifiers and should be included in portfolios to reduce risk and volatility.

Asset Class	Overall Correlation to US Bond Aggregate
US High-Quality Bonds (Aggregate Index)	1.00
US Treasury Bonds	0.94
Global REITs	0.27
Cash	0.15
Global Infrastructure Equities	0.13
High-Yield Bonds	0.10
Emerging Market Stocks	-0.02
Commodities	-0.13
Foreign Developed Market Stocks	-0.13
Bank Loans	-0.17
US Large-Cap Stocks	-0.23
US Small-Cap Stocks	-0.30

Source of Date: HFRI, Morningstar.

Risk Management at Laird Norton Wealth Management

Our focus at Laird Norton Wealth Management is on fully informed, intelligent risk-taking. We strive to understand and exploit investment opportunities as they arise and to manage your overall portfolio risk by diversifying exposures to various asset classes. To do so, we apply robust risk analysis, including quantifying market risk, understanding how assets move together (or not), and "what if" scenario analysis, both before and after we invest.

Look at the questions in the box below. For each client portfolio, we answer questions like these not just once but all along the way. This makes it more likely you will benefit from (1) a consistent strategy that keeps you invested through market downturns; and (2) more stable cash flow.

LNWM Portfolio Risk Analysis

- **Probability of a loss:** What’s the probability your portfolio will lose value in any one year? What's the probability of a 10%, 20% or 30% price decline?
- **Stress-testing and worst-case scenarios:** What is the most you're likely to lose in any one year?
- **Risk forecasting:** What level of confidence can you have in your portfolio’s performance (risk and return) assumptions?
- **Risk profiling:** What level of price volatility can you and your finances realistically sustain?
- **Risk/return optimization:** What portfolio holdings are most likely to get you the highest "real" return (after taxes and inflation) for that level of volatility?
- **Hedging strategies:** In worst-case scenarios, which alternative investments are likely to be the most effective hedges?

Where’s the Hedge?

Hedge funds offer different levels of correlation to stocks, which can lower risk without sacrificing returns over time.

Find out how

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