Investment Insights
3 Ways Flexible Asset Allocation Can Help in Overpriced Markets

Key Takeaways
- A flexible asset allocation approach and a dynamic risk profile can adjust portfolio risk to match valuation opportunities.
- Using index data, we show hypothetical portfolios of two assets where a simple, hypothetical strategy that adjusts allocations based on past performance outperform static portfolios while also carrying less risk.
- Absolute benchmarks, valuation-driven asset allocation, and looking beyond core asset classes are three ways to make portfolios more flexible and perhaps more robust to handle any investment environment.

Overpriced Markets, Take 2
Pick a measure, any measure, and you can make the case that U.S. equities are overpriced. The P/E, the cyclically adjusted P/E (or 10-year P/E), and market capitalization/GDP ratios are all near or above all-time highs.

In our own valuation work, we see few major markets that are attractively priced. It’s not just U.S. equities, but U.S. bonds and others have—since March 2020—moved from being in many cases attractively priced to being overpriced. This raises the question of what to invest in when attractive valuations and conviction have diminished.

The Case for Flexibility
Taking a flexible approach to asset allocation may help investors reach their financial goals through any market environment by dialing risk up or down in response to market prices. Pricing is a key part of flexibility because higher prices often indicate higher risk to investors as they can lead to lower returns, while lower prices can mean lower risk and higher potential returns.¹

We performed a simple data study that illustrates how a hypothetical flexible portfolio might respond to market prices—as prices climb longer, they are more likely to become overpriced; conversely, after a major decline they are more likely to be attractively priced. We then compared this flexible portfolio over time to a hypothetical static portfolio of 50% global stocks/50% U.S. Treasuries². The flexible portfolio

¹Valuation-based risk might be illustrated by a ticket scalper during the pandemic. Imagine you buy and resell tickets to events that may or may not take place due to transmission levels at the time of the event. There are two events six months away, both with $100 ticket prices. You can buy tickets (to resell to others) for one event at $50, while the other event’s tickets are selling for $130. Which presents a higher risk to you, and which a better opportunity?
²Global stocks are represented by the MSCI World NR USD index, while Treasuries are represented by the Bloomberg Barclays US Treasury TR USD index.
also starts at a 50/50 allocation but then adds 3 percentage points to equities whenever stocks fall by an incremental 10%, and trims equities by 1.5 points after an incremental 10% rise. We then repeated the exercise using the more common 60/40 portfolio allocation.

Why would the flexible portfolio add more stocks after a decline than it would increase them after an increase? This asymmetric approach was designed to reflect the long-run performance of markets. Historically, stocks have generated positive returns (about 8% annualized) over long periods, while experiencing drawdowns (or major losses) only occasionally. The long-run growth of stocks appears to be driven by fundamentals—that is, growth in earnings and payouts, like dividends and share buybacks. Thus, our simple model seeks to reduce stock exposure during growth periods about half as fast as we increase it during drawdowns.

Looking at the results of this test, we suggest there are three ways flexible or dynamic portfolios can help investors.

Exhibit 1 The Hypothetical Flexible Portfolio Has the Potential to Outpace the 50/50 Over the Long Haul

Source: Morningstar Direct. These hypothetical portfolios use combinations of the MSCI World NR USD and Bloomberg Barclays US Treasury TR USD indexes. The 50/50 portfolio rebalances weekly. The flexible portfolio starts at 50/50, then adds 3 percentage points to equities whenever the index falls by an incremental 10%, and trims equities by 1.5 points after an incremental 10% rise. Weekly performance data as of 12/26/2020.

1. Preparing for Performance

Looking at exhibits 1 and 2, the most obvious takeaway might appear to be the fact that the flexible portfolios outperformed the static portfolios over time. Long-term performance matters—that growth helps investors reach their long-term goals.

How could a portfolio that is underweight equity keep pace, even as stocks rallied? The reason is that the flexible portfolios had less equity before market sell-offs and had their highest equity holdings as the
market began to recover. Therefore, they limited the downside and participated more in the upside. Given the nature of compounding returns, the flexible portfolios kept up with the static portfolios despite being underweight equities on average over the test period because it was able to take advantage of growth at key times.

Importantly, this study limited the investment options to global equities and Treasuries. A truly flexible strategy in the real world would hope to provide additional excess return through intra-equity and intra-bond positioning.

2. Helping Investors Focus on the Long Term
The hypothetical flexible portfolios do not require clairvoyance or knowledge of future stock returns. They simply add risk as markets go down with no clarity as to when the “bottom” might occur. This is in contrast to the static portfolios, which rebalance to 50/50 or 60/40 every week.

Although the flexible portfolios didn’t “call” the market bottom, they were prepared for it. That can be harder for us humans, though. When markets plummet, it can be painful as we watch our balances shrink ever smaller. Similarly, when markets rocket upward, we tend to feel bulletproof, even though history teaches us that all rallies eventually end—many tragically.
This may be one behavioral drawback of a flexible portfolio in the real world—it will reduce allocations to stocks and risk at times when investors feel the most ready to take on risk. That can hamper returns in the short run. And, at times, these periods of stocks moving ever higher can be extended, giving the investor feelings of fear of missing out. This, too, can be a danger, as an investor may be tempted to sell out of flexible strategy to dive fully into the market rally, only to be caught holding more risk when markets retreat.

So, flexible portfolios aren’t fix-alls for behavioral missteps. But because they tend to reduce equities after major price rises, they experienced lower maximum drawdowns during the test period. Protecting on the downside not only helps future returns, but it also can lead to better investor behavior—making it less likely a client exits the market at the worst time, which is at or near the bottom.

3. Reducing Risk
As important as competitive total returns may be, the hypothetical flexible portfolios boasted better risk metrics, delivering a smoother ride and better risk-adjusted returns.

Exhibit 3 shows the details here. While outperforming, the flexible portfolios held a lower equity allocation over the period. Not only that, but they lost less on the downside and reduced volatility. The result was higher Sharpe ratios—a measure of portfolio efficiency—for the flexible portfolios. Note that the flexible strategy that started at 50% equity kept pace with the static portfolio that held steady at 60% equity.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Average Equity %</th>
<th>Annualized Return</th>
<th>Volatility</th>
<th>Max Drawdown</th>
<th>Sharpe Ratio</th>
</tr>
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<tbody>
<tr>
<td>Flexible 50/50</td>
<td>47%</td>
<td>6.7%</td>
<td>8.1%</td>
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<td>0.57</td>
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<tr>
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<td>8.3%</td>
<td>-28.3%</td>
<td>0.53</td>
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<tr>
<td>Flexible 60/40</td>
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<td>6.9%</td>
<td>9.7%</td>
<td>-34.0%</td>
<td>0.51</td>
</tr>
<tr>
<td>Static 60/40</td>
<td>60%</td>
<td>6.7%</td>
<td>10.0%</td>
<td>-34.6%</td>
<td>0.48</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct. These hypothetical portfolios use combinations of the MSCI World NR USD and Bloomberg Barclays US Treasury TR USD indexes. Static portfolio rebalance weekly. The flexible portfolios start at 50/50 or 60/40, then add 3 percentage points to equities whenever the index falls by an incremental 10%, and trim equities by 1.5 points after an incremental 10% rise. Weekly performance data as of 12/26/2020. The performance shown is that of hypothetical portfolios. This is not a reflection of actual clients’ portfolios. Past performance is no guarantee of future results.

The Same Principles Apply to Income Strategies
Income-producing assets (fixed income, dividend-yielding stocks, etc.) cycle through periods of being cheap and expensive just like broad equity markets. And being caught overexposed in a period where they move from expensive to cheap can not only lead to large capital losses, but it can also harm an investors’ ability to take advantage of higher yielding opportunities after prices have fallen.

In an environment where yields are low and credit spreads are tight (like today), it can be tempting to reach for yield and allocate capital to the highest yielding asset classes (which is often a place like
corporate high-yield bonds). But investing in an asset class like high yield in an expensive market is a dangerous game, and investors can experience losses similar to equities in market sell-offs.

When credit spreads tighten, prospective returns become asymmetric to the downside. It’s a double-whammy in that investors—compared to an environment of lower prices and wider spreads—must accept lower relative yields while taking on even more risk. Sure, yields might still beat Treasuries, but if the market turns, that yield offers very little protection and you can experience significant capital losses.

Exhibit 4 Today’s High-Yield Credit Spread Is Near Levels Seen Before Large Drawdowns

![Graph showing credit spread data]

Source: Morningstar Direct. OAS, or option-adjusted spread, is the difference in yield between high-yield bonds and Treasuries. It is a measure of the compensation an investor is offered for taking credit risk of less-secure issuers. Data as of 02/24/2021.

A Willingness to Be Contrarian

All of this gets at flexibility, but we might also think of it as a willingness to be contrarian—to go in a different direction than the masses based on your conviction. Warren Buffett has famously described this as being “greedy when others are fearful, and . . . fearful when others are greedy.” That, coupled with a long-term mindset, may keep an investor focused on long-term goals, which in turn could help in reaching them.
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