Why a Balanced Portfolio Strategy in the current economic environment is no longer appropriate?

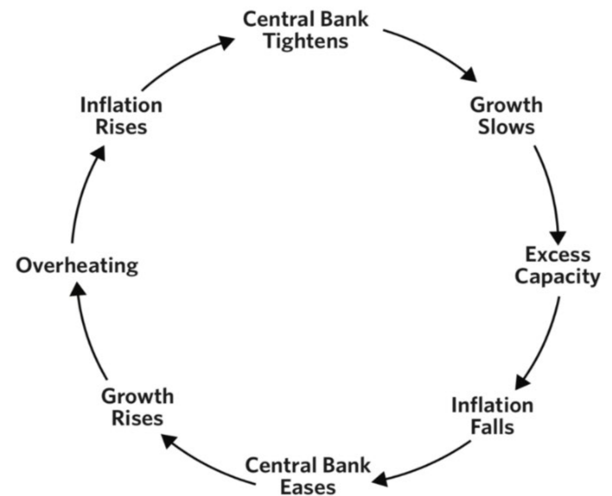
In the past a balanced portfolio typically meant to have roughly half of your holdings to be equity (stocks) and the other half to be fixed income (bonds). Some people use a 60/40 weighting, respectively.

In economic studies, there is the idea of economic cycles also called boom/bust relationships. There is a video by Ray Dalio on our website called "How the economic machine works" highlighting this relationship.

Here is short summary of it:

The source of an economic expansion is a central bank buying bonds (which has the effect of lowering interest rates) and fueling cash into the system and government's favorable fiscal policy (less taxes) also participate in helping this expansion. This helps companies finance their operations (hire more people and buying equipment etc.) and increase their economic output. As more people work, their salaries also tend to go up and they increase their spending, stocks rise as companies make more money fueled by the fiscal stimulus and/or monetary policy. While this expansion is great at first, it also drives demand of goods and services which fuels inflation (the rapid increase of prices for those goods and services as more and more people are able and willing to spend). To keep inflation from heating up, the government raises taxes and/or the central bank sells bonds and gets cash which "removes" cash out of the banking system making it scarce. This is to decrease inflation. And from there the cycle restarts again.

With an abundance of bonds available to be bought whenever the central bank decides to tighten the economy through bond buying (companies are now competing to raise money with a central bank), this tends to drop the prices of bonds and raise the interest rates, making it harder for companies to get the cash needed for their expansionary goals and operation. Unemployment increases as companies try to control their costs and this decreases demand for goods and services hence taming inflation.



As you may notice and infer from above, during the early cycle of the economic expansion rates are low (bond prices high) and stock prices typically low as companies are not yet making much money and are scrambling to get financing. As they get financing from a low rates environment, stock prices from those companies tend to increase but as inflation goes up shortly after, the market anticipates government and central bank policies and price-in those controls and rates start to rise (bond prices lower) and the cycle continues.

This has been the Keynesian relationship that has been promoting the balanced portfolio as a long-term strategy for years because it allowed for that inverse relationship between bond and equity prices. It all worked for as long as we had that relationship.

But what happens when the central bank does not account for the ever-increasing efficiency of companies supported by super computers and algorithms? What happens when it misses its calibration by letting too much debt flow in the hands of individuals and companies? As companies become more efficient with machines, they do not need to hire as much or at least pay wages high enough to allow for an accelerated inflation. Cash is plenty but inflation is low too, which means it does not need to be tamed anymore. If the central bank raises the rates, plenty

of people will suffer by losing their homes or other assets to service or pay their debts. The stock market is at an all-time high due to ever ending bond buying from the central banks to keep rates low enough for proper consumption. More central bank stimulus would yield ever more cash and potentially negative rates…which happened in Europe.

What is the suitable portfolio strategy for a long-term investor in such circumstances?

We believe that the old balanced portfolio strategy is not suitable in the current environment for many long-term investors if you are sticking to North America. As a matter of fact, we believe that unless it is inflation adjusted or is a value play (which is rare in the current environment), we suggest steering away from bonds as a group. A bond portfolio is not and should not represent any significance in a client portfolio at the current rates, if you are not willing and ready to look beyond North America, Europe or Japan which are all suffering from this low rate debt trap.

Alternatively, in these same regions, the most compelling investments aside from select sectors within the stock market are within the private equity (private companies), real assets and real estate sectors where you can find the most value relative to risk.

As a company, we have always believed in risk diversification across sector and geographical regions. Instead of the old balanced portfolio strategy, we recommend our global pension style strategy, which looks at all assets classes and select those most appropriate to complement our equity strategy.

The current state of our portfolios

Our portfolios have maintained a sustained performance during and after the pandemic, as we have taken a proactive and diversified approach. We use a continued tactical rebalancing for a portion of our portfolios to trade in and out of positions; We hold core positions composed of various positions in the asset classes we mentioned above. All our clients' portfolios are positive for 2020 and beating their benchmarks. We have been doing better than those indexes for years thanks to our openness to opportunities wherever we may find them all the while maintaining our commitment to Environmental, social, and corporate governance (ESG).

If you have a portfolio invested in mutual funds at a bank or elsewhere, get in touch with us to explore how our strategy may benefit you.

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