STONE

Sleep well.

Overcoming the 5 Big Investor Challenges in Volatile Markets

WHITE PAPER

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Introduction

In a perfect world, markets would rise steadily and economies would ease into newly profitable sectors. But it's not a perfect world. The reality is that markets are volatile, and economies shift dramatically and unexpectedly.

Amid ever-changing markets, investors face five big challenges as they work toward their financial goals:

1. Grow assets
2. Generate income
3. Capture upside through active management
4. Diversify assets
5. Manage tax efficiently

To help investors steer through these challenges, advisors and investment managers are responsible for:

- Growing investors' principal
- Navigating changing interest rates
- Managing the perils of inflation

These three responsibilities are tightly interconnected – and one or more will take priority to overcome each of the five investor challenges.

CHALLENGE 1

Investors Need to Grow Their Assets

What matters most is how those assets grow

Asset growth is why people invest in the first place – to get their money working for them. Otherwise, they could keep their money in savings accounts or under a mattress. Investing helps people stay ahead of inflation – or at least stay even. And the collapse of defined benefit pension plans in the private sector makes investing for retirement a must.

But what does growing assets well mean? It means mitigating downside risk – week after week, month after month and year after year. Passive investing, with its strict buy-and-hold approach doesn't meet this need – especially for investors in or near retirement, or those using their portfolio as a source of income. Instead, an active approach that does not trade excessively lets investors mitigate downside risk and capture upside.

The timing of negative returns is important

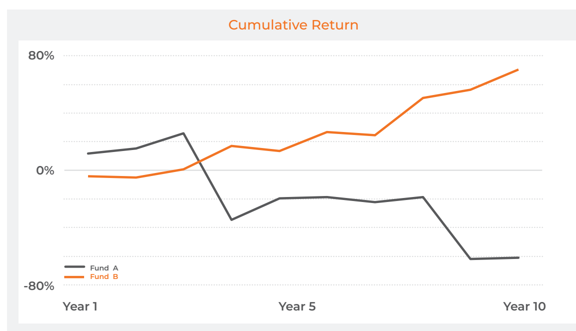
Looking at long-term returns is problematic for two reasons. First, as we all know, past performance is not indicative of future returns. Second, and less known, is that long-term returns such as five-year performance can hide the important reality of shorter-term volatility. For most investors, especially those approaching or in retirement, future financial well-being is linked to volatility and the sequence of returns. If there is a market downturn when an investor starts taking income from their investments, they will have less income to draw for their entire retirement.

Over a five-year period – 60 months – one investor has a number of months with strong outperformance and just a few months of dramatic underperformance. The other investor has slow and steady returns that are much less volatile.

Which investor is closer to achieving their goals at the end of the period? Slow and steady won the race. Helping your clients understand the bigger picture can help take the focus off the short term and shift attention to their success over the long term.

Fund A	
Year 1	12%
Year 2	3%
Year 3	9%
Year 4	-48%
Year 5	23%
Year 6	1%
Year 7	-4%
Year 8	4%
Year 9	-53%
Year 10	2%
Success Rate	70%
Average Performance	-5%
Standard Deviation	25%

Fund B	
Year 1	-4%
Year 2	-1%
Year 3	6%
Year 4	16%
Year 5	-3%
Year 6	12%
Year 7	-2%
Year 8	21%
Year 9	4%
Year 10	9%
Success Rate	60%
Average Performance	6%
Standard Deviation	9%



Difference between return *on* principal and return *of* principal

A key concept to understand is that to achieve return *on* principal (growth), advisors and investment managers need to generate appropriate returns for an investor's time horizon, risk tolerance and goals. And, to avoid return *of* principal, they must mitigate downside risk by exiting losing positions or investments in which advisors and investment managers have less conviction. This concept is present within each of the five big challenges investors face.

> "To achieve ***return on principal***, we must generate appropriate returns for an investor's time horizon. To avoid the risk of ***return of principal***, we must mitigate portfolio downside risk."
>
> *– Richard Stone*

CHALLENGE 2

Investors Need to Generate Income

Accumulators become decumulators – and the direction of interest rates is a factor that must be understood

Money accumulators eventually become money decumulators. It is a fact of investing life. When investors enter the transition between the two, everything changes. Portfolios become highly sensitive to interest rates given their bias toward securities such as high-yield bonds, real estate and dividend-paying equities. These investment types directly reflect the impact of interest rate changes.

We can frame this challenge within the idea of return on principal versus return of principal. For investors who are decumulating their assets, generating a higher income means spending less principal. Investment managers and advisors must aim for an income that is above a client's requirements without exceeding the investor's risk tolerance. The typical gap between government benefits and the amount most investors need is between 3.5% and 6.5%. That is the range to aim for when using a portfolio to generate income.

Effects of higher interest rates

Situation	Effect	Result
Borrowing is more expensive ▸	Less investment ▸	Lower economic growth
Higher payments on mortgages ▸	Decreased spending ▸ House prices fall ▸	Lower economic growth
Higher savings rates ▸	Decreased spending ▸	Disinflation

Interest rates are an eye into the future

Interest rates influence all markets and can tell experienced and observant investment managers what will happen. For example, rising rates result in higher mortgage costs, which in turn result in reduced consumer spending. Housing and retail, two massive sectors – and the companies that operate and have exposure to these areas – will perform much differently when interest rates go up. If clients who depend on investment income hold interest-rate sensitive high-yield bonds and dividend-paying companies (such as highly-levered companies and utilities), portfolios may need rebalancing.

A portfolio's allocation to government versus corporate bonds, cash, dividend-paying companies and other yield-focused investments must be managed for interest rate changes and their economic impact.

> "Our experience shows that the typical gap between government benefits and the income that most investors need is between 3.5% and 6.5%."
>
> – ***Richard Stone***

CHALLENGE 3

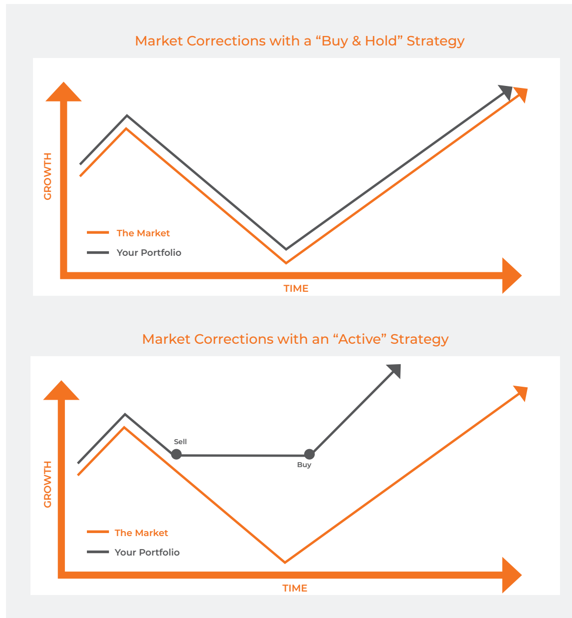
Investors Need to Capture Upside

Active management, unlike passive, can mitigate downside risks

In sports and war, the best defense is often a good offense. When investing, the opposite is true: the best offense is usually a good defense. That is, to capture the most upside, you need to avoid capturing the downside.

Both active and passive investing approaches have a role to play in well-diversified portfolios. How assets are allocated between the two becomes increasingly important the more volatile markets become. Why? Whereas with passive you get 100% of the downturn, you can mitigate the downside if you are an active manager. And active managers do add value: according to Goldman Sachs Global Investment research, the majority of active large-capitalization mutual funds outperformed their benchmarks in 2018.

Active mitigates the downside better than passive



Passive investing is incredibly popular when markets are up: everyone is happy to earn as much as everyone else. But everyone is rarely happy to lose as much as the crowd. As markets remain volatile and trending down, the rush to 100% passive portfolios is probably unsustainable. As markets remain volatile and trending down, passive will be pushed to the test.

It's unlikely that passive investors know what to do when things get bad. Not only will they have to time the market, they must first learn *how* to time the market. This is a recipe for disaster.

To stay ahead, astute investors seek out active investment managers who are nimble yet cautious and ready to act. Active does not mean excessive trading. It means being prepared, being prudent, knowing what is going on with interest rates, inflation and other factors that influence markets. Active management is being able to ask, "Where am I in relation to the markets today?" Sometimes it takes great conviction not to react and trade for the sake of trading. Being active is about using investment skill to make that call. That is what helps clients sleep well.

Passive is efficient ... until it isn't

At the root of the rise of passive investing is the evolution of technology. Passive is not better – it is just a more efficient way to get broad market exposure. Like all investment choices, it has its limitations. The fundamentals of investing have not changed, and therein lies one of the weaknesses of passive investing. Active managers with a long-term, disciplined investment approach can use market corrections as buying opportunities. Passive investors cannot capitalize on down markets or volatility. All passive investors can do is ride (and wait) it out, or be a market timer.

> "As passive investors discover during market downturns, to achieve ***slow and steady*** returns, investors must be ***active and ready***."
> ***– Richard Stone***

CHALLENGE 4

Investors Need to Diversify Their Assets

Looking at diversification through the lens of inflation is essential

Coupled with fundamental analysis, we believe an essential and often misunderstood element of all robust investment disciplines is top-down macroeconomic insight. This is especially true when managing the perils of inflation – a rarely talked about yet core responsibility for advisors and investment managers.

Geopolitics, macroeconomics and other large-scale financial and economic concerns may seem too big to worry about – or manage for – but they impact individual investors, particularly when there is a shift from one stage to another. This is when active management is highly valuable – repositioning portfolios to mitigate risks and capture opportunities.

As you can intuit from the economic growth and inflationary environment table below, fundamental analysis remains essential but is insufficient by itself when you need to manage inflationary, disinflationary, deflationary and even stagflationary environments.

Advisors and investment managers with top-down macroeconomic insights – and investing experience in all market conditions and economic environments – can identify the trend, and rebalance portfolios accordingly.

History shows that different economic and inflationary environments have dramatically different effects on asset class performance. The future will likely be no different.

How does this look in practice? Top-down insights, such as identifying trends in inflation, will inform overall asset allocation to cash, bonds and equities. Inflation also influences diversification decisions within each asset class, such as fixed income exposure between federal and provincial bonds, or equity exposure between large- capitalization and small-cap stocks. Securities perform differently as we move through economic cycles. Investors need to know how these broad macro issues impact individual investments, especially when they are positioning their portfolio during volatile times.

Economic growth and inflationary environments impact asset class performance

	Rising Inflation	Slowing Inflation
Rising growth	*Inflationary "boom"* Domestic equities Foreign equities Small-capitalization equities Real estate Commodities	*Disinflationary period* High-quality domestic equities Investment-grade bonds

The investment sweet spot ... is never static

Top-down macroeconomic insights do not control overall asset allocation. Rather, they inform it when coupled with good critical thinking, common sense and smart decisions. Long-term issues and topical short-term issues are considered and weighed. When these are in alignment with a disciplined process, advisors and investment managers should act by adjusting a portfolio's asset allocation tactically. This is smart diversification. It is dynamic and always active.

> "Top-down insights are valuable when they are informed by critical thinking, common sense and smart, prudent decision making."
>
> – ***Richard Stone***

CHALLENGE 5

Investors Need to Manage Tax Efficiently

And they need the help of advisors to do it well

To invest well, you need a passion for it. To invest well and capitalize on tax efficiencies, you need passion and expertise. Very few individuals possess both, which is why they should work with advisors. Guidance and insight into an individual's or a family's unique circumstances, examined holistically, is the only path to improving tax efficiency effectively and appropriately.

A recent Harris Poll* out of the U.S. revealed two interesting facts about affluent individuals and tax efficient financial planning:

- Tax planning is important to the majority of the affluent
- 87% said that adjusting their financial plan would help them achieve at least one of their financial goals.

While tax planning may be one of the most complex areas of financial planning, it also deals with one of the most emotional aspects of investing – advisors are protecting their clients from outliving their assets.

Tax-efficient investing and financial planning offer advisors low hanging fruit for adding value to their clients. It is a vital service, especially if advisors want to make client assets stickier over the long term.

Here are five ways advisors can improve their clients' tax situation. We recommend advisors offer these services to make a lasting impact.

5 ways to improve client tax efficiency

Tax-loss harvesting	Know when to sell an investment in a taxable account to realize a tax loss. Know how to do it effectively while maintaining appropriate asset allocation.
Asset location	Know which investments to put in which account/plan type. For example, putting interest-paying securities in registered plans could improve tax efficiency.
Withdrawal planning	Know which accounts to draw money from (for example, registered vs. non-registered). Timing this properly could reduce taxes in a given year.
Donations	Know which securities to donate; for example, an equity investment that will incur significant capital gains could be donated to minimize tax burden.
Strategic rebalancing	Know the impact of rebalancing, especially in non-registered plans. There are significant potential benefits for clients moving from the accumulation to decumulation phase.

* Source: https://www.fa-mag.com/news/majority-of-affluent-americans-seek-tax-efficient-financial-plan-37560.html

> "You need a passion to invest well. You need passion and expertise to invest well and capitalize on tax efficiencies. That is rare. And that is why investors should work with advisors."
>
> *– Richard Stone*

CONCLUSION

It All Comes Together in Strong Relationships

Stone solidly embraces the advisor-client relationship

Advisors and investment managers who understand their three core responsibilities – to grow principal, navigate changing interest rates and manage the perils of inflation – will help investors overcome the five big challenges.

Thought leadership matters, and a great investment manager does not simply manage money. They solve problems and provide differentiated, out-of-the-box thinking, giving advisors an edge over their peers – and helping their clients sleep well, knowing they'll have the financial resources to live well.

To learn more about how Stone supports advisors, contact us today at 416 364 9188, 1 800 336 9528 or info@stoneco.com.

STONE
ASSET MANAGEMENT LIMITED

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