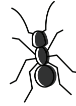
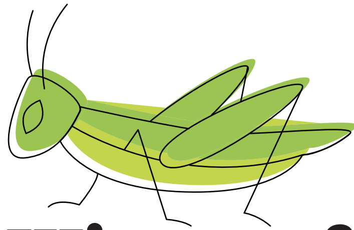
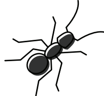
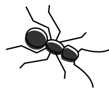




Winter of our discontent



We might soon find out who prepared for a downturn and who didn't



›BY ARTHUR SALZER

THE STORY OF THE GRASSHOPPER AND THE ANT, which has its origins in *La Cigale et la Fourmi* by Jean de la Fontaine, tells of the preparations an ant makes during the pleasant weather of summer while the grasshopper merrily sings, only to find herself destitute during the depths of winter.

During this past decade we have experienced one of the longest and most favourable investment climates due to the immense liquidity that central banks around the world flooded the market with. Quantitative easing combined with negative interest rates forced investors to reach for yield and risk in order to achieve a return. However, we are beginning to see this liquidity subside and we were given a hint of the volatility that may follow this past December. Here are some easy ways to prepare.

ENSURE THAT YOUR SPENDING IS COVERED

Is your spending covered for a period of time? Do you know what percentage of your investment portfolio you spend every year? If it's 3% or less, then somewhere between 10% to 15% of your overall portfolio should be in lower-risk investments such as cash, treasury bills or short-term, high-quality bonds. This equates to three to five years of spending and should provide moderate to ample coverage for any extended bear market. Why as much as five years? It's because most bear markets are shorter. The recent Great Financial Crisis, where markets plummeted from 2007 until March 2009 then returned to market highs, took less than four years, although this was due to the to the excessive intervention of the U.S. Federal Reserve and other central banks.

> "We are beginning to see liquidity subside and a hint of the volatility that may follow

For those who are older or have studied market cycles, the 1970s provided an environment where markets drifted sideways for many years. Even during the Great Crash of 1929, markets only went down for four years, and then had a huge rebound in 1933. Having your spending needs maintained during these bear markets and having the ability to buy assets at steep discounts when less prepared (or distressed) investors are forced to sell can dramatically improve portfolio returns.

However, what if your family spends 5% of your portfolio (which is similar to charitable foundations) or even more? According to our suggestion, 5% spenders should have somewhere between 20% and 25% of their overall portfolio in cash, equivalents and/or high-quality fixed income. Since families aren't institutional investors, it's difficult for them to rely on new sources of capital such as donor contributions to cover market losses. Therefore, it's prudent to accept a moderate reduction in potential returns during the late stages of a bull market in order to reduce the risk of a large decline of capital value during a bear market.

BE DIVERSIFIED

One of the tenets of investing is to be diversified across multiple asset classes such as cash, bonds and stocks and, if possible, have exposure to alternative asset classes like real estate, private equity and debt, as well as strategies that have low correlations to the stock and bond markets. A simple approach to ensure adequate diversification is the creation of an investment policy statement (IPS) — essentially a long-term investment strategy — within which the desired range of exposure to each asset class and manager is outlined. These ranges are based upon long-term and non-emotional risk and return expectations and provide guide rails when markets turn volatile. The importance of an IPS cannot be overstated as it is a necessity for pools of capital that will be relied upon to meet future spending needs.

Investors should examine the various asset classes on a regular basis (say, quarterly) and ensure that no asset class has exceeded the stated guidelines. Rebalancing consists of selling/redeeming some of the better-performing investments and investing the profits into under-allocated asset classes in order to bring the portfolio back to within the IPS guidelines. Portfolio rebalancing will have some tax costs, but it makes sense to pay some taxes in order to preserve gains given that we are late in the economic cycle.

STRESS TEST YOUR PORTFOLIO

If you have access to a simulator that can perform stress tests on your current portfolio, subject it to various historically bad market events such as the overlapping sideways markets of 1968-1982, the 2001 tech crash, the Russian financial crisis in 1998 and the recent Great Financial Crisis. The results of these simulations should provide a better picture of the potential carnage to your portfolio's market value during bad times. Then ask a few questions: Would your current lifestyle be maintained? Would you be able to withstand the mental anguish and not be induced to sell out and go to cash at the bottom of the market cycle? And, lastly, do you strongly believe the answers you just gave yourself to the previous questions?

Of course, almost every investor has a higher risk tolerance when markets are strong and a much lower risk tolerance when markets are in free fall. As a result, although stress testing can be useful, the pain and remorse of significant capital (albeit paper) losses are not fully known until experienced.

Like la fourmi, the ant in the story, it's never too early to begin planning for the next winter or bear market. **FPM**

Arthur Salzer is CEO and chief investment officer at Northland Wealth Management.

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