Tacking is sailing in a zigzag pattern across the wind

# Tacking through the chop

Why investors will have to take a page from the sailor's handbook to stay ahead of the market ›**BY ARTHUR SALZER**

**AS SAILORS KNOW,** different tactics are necessary when sailing into the wind as opposed to sailing downwind. The ability to tack, sailing in a zigzag pattern across the wind, is a necessary skill to learn in order to make progress when the wind is against you. Likewise, in order to be a successful investor over the next two decades, it will be necessary to use various strategies so portfolios can progress. The reasons are simple: the 10-year Government of Canada bond is yielding in the 1.2% range and the expected returns for stocks are lower than the past 30 years, so the coming headwinds for investors may create disappointment, and potentially put greater strain on political systems if retirees, pensions and multi-generational families experience great difficulty meeting their return targets.

The easiest approach an investor can take is simply to accept that returns will be lower and reduce expectations and spending habits accordingly. This may already be taking place, judging by the economic doldrums and low economic growth rates experienced since the Great Recession of 2008. However, investors such as endowments have annual spending targets of 4% of their overall capital while pensions need 7%-7.5% to have sufficient capital to meet their obligations. And while some families may reduce their spending, many will refuse to live within the new and reduced constraints. As a result, investors are looking for something new to buoy returns.

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One strategy may be to take on more risk. Many investors use a ratio of 70% equity to 30% fixed income, with variations based upon their own unique risk tolerance. If stocks generally outperform bonds, does raising exposure to stocks solve the return issue? The answer may be yes, according to Warren Buffett, who explicitly directed his executors to invest 90% of his wife's trust assets in the S&P 500 and the remainder in bonds. Based upon the research of Javier Estrada at IESE Business School in Barcelona, using a 4% withdrawal rate, this portfolio should fail only 2.3% of the time over 30 years. His research also shows that given current interest rates, higher bond allocations would result in higher failure rates. The drawback, however, is that the likelihood of selling the stocks at the wrong time is extremely high since drawdowns have in the past reached and exceeded 50%.

What about trying to beat the market? Many investors have recently embraced passive investing since around 80% of active equity managers underperform a benchmark such as the S&P 500 index, especially after fees. Passive investing has worked very well for the past 30 years, but market returns for the next couple of decades will likely be lower. At the same time, extreme active management, like the type hedge funds do, is also having a difficult time generating excess returns. However, hedge funds with lockups have tended to outperform their more liquid brethren. And factor investing, or what people call smart beta, has also performed well against the market and, in some cases, provided higher returns for lower volatility. Finally, sectors that have higher margins than the overall market, such as information technology, media companies and pharmaceuticals, may have higher return potential, all things being equal.

Private equity is another option, and is something pensions, endowments and multi-generational families often invest in since they have multi-decade-long investment horizons. A well-managed private-equity portfolio has provided returns of the public equity markets plus five percentage points over the past 30 years. However, the spoils of this sector go to the top quartile of private-equity managers and many investment minimums are in the $5-to-$10-million range. Hiring a good outsourced chief investment officer may gain access to these opportunities at lower minimums.

Due to the increased regulatory environment that banks worldwide are operating in, banks have greatly reduced their lending to mid-sized companies and real estate developers. This has created opportunities for specialized, professional lenders to fill the funding gap. The result is loans priced at 6%-12% depending on the quality of the borrower and the security pledged. The drawbacks are lockup terms ranging from 12 months to 10 years and, in many cases, the investor must be accredited. Careful due diligence and access to high-quality managers in this area is necessary.

Finally, opportunistic and distressed investing, while not usually included in many investment policy statements, can play a contributing role. Typical exposure should be in the 5%-7% range initially in order to have a large enough position to positively affect a portfolio. Current opportunities can be found in areas such as distressed credit, where managers specialize in financial restructuring, or real estate in the U.K., which has suffered recently due to Brexit and the declining pound.

No matter which route is taken, successful investors need to adjust their tactics in order to progress against the coming headwinds, just as successful sailors have learned how to tack. **FPM**

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