Equities: I can’t live with you, I can’t live without you

14 December 2020 | Mark Beardow, Darling Macro

Equities are the foundation of many portfolios but investors have learned to expect infrequent large losses. So how can we make it easier to live with the risk of these drawdowns?

I think its uncontroversial to say that equities are the foundation of many portfolios and have generated returns well above cash and inflation over the long term. However, investors have also learned to expect large but infrequent losses, as large as 40 to 50%. Think about 1974, 1987, 2000, 2008, 2020. During February and March 2020, Australian equities fell 36%.

So when Queen sang "I can’t live with you, I can’t live without you", perhaps Freddie Mercury was singing about equities.

While investors have learned to expect these losses, they have also found it hard to live with equities at times. For example:

- The overwhelming response to the early release super scheme after the market drawdown resulted in outflows from equities which were reinvested into cash and savings accounts,
- Investors within super which saw switching from equities to cash, and
- Your friend or colleague who confided that they "went to cash" during March and April.

So how can we make it easier to live with the risk of these drawdowns, we think there are 3 categories of action:

1. Diversification beyond equities - such as government bonds, or holding unhedged foreign currency denominated assets, widely used but sensitive to assumptions,
2. Timing based techniques - which may be hard to implement, and
3. Options, convex strategies such tail risk hedging - which may be expensive.

A really interesting 4th technique is the importance of managing our own behaviour as investors, and managing the risk that we may panic as markets capitulate and hit the bottom. For example,

- Advisers, that I know, focus on coaching their clients to be ready for times like February and March, believing that managing behaviour is one of the truly controllable things we can do,

- A friend tells me they are a long-term equity investor and refuses to setup online super access which would allow impromptu switches,
- Another friend chooses to invest in property knowing that they cant easily sell out,
- An ex-colleague of mine advocates the importance of keeping a clear head and managing their position size to avoid the prospect of forced sales,
- Finally, others advocate a rules based or systematic process for dealing with investment decisions.

How should these risk management actions be assessed? We think these two approaches are complementary

1. Does the technique lead to quantifiably higher risk adjusted returns?

Judging total performance against different measures of risk. This approach uses ratios such as Return to risk, Sharpe, Sortino and Burke

2. Does the technique lead to 'confident' investors who are better able to hold the strategy through the inevitable booms and busts

More confident investors are more likely to retain a longer term perspective; and thus resist reducing after surprising underperformance and resist increasing allocations after shorter term unsustainably positive performance,

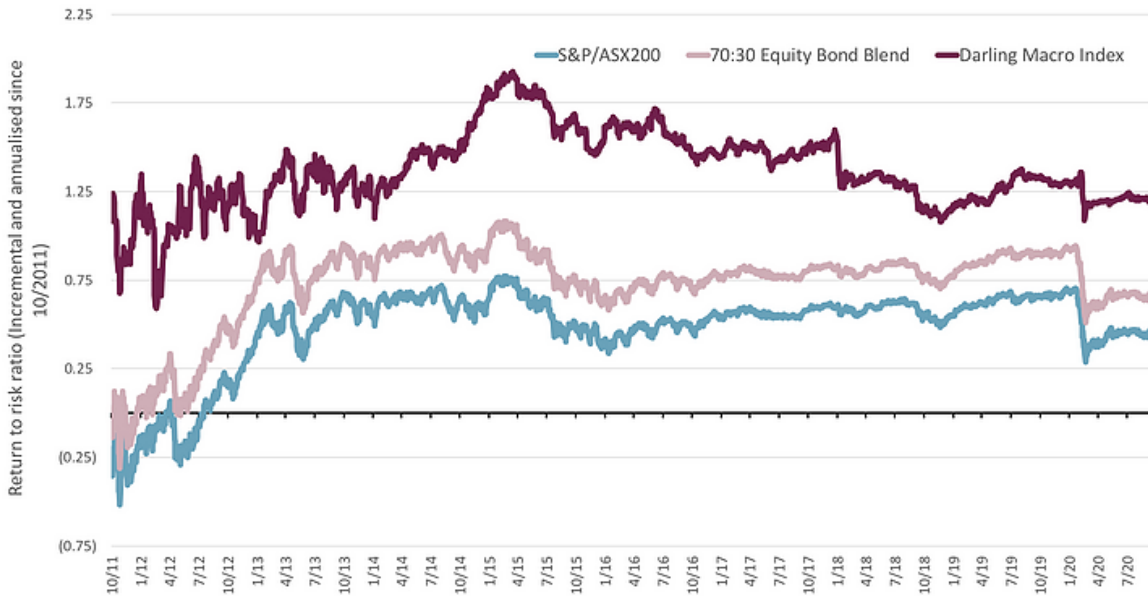
We measure this by comparing time weighted returns with money weighted returns. Most funds are reported on a time weighted basis but money weighted returns weight returns to the amount invested, if these are closely matched then it is an indication of more 'confident' investors. Morningstar and Dalbar conduct some excellent studies on this and one of their conclusions is that funds with higher risk adjusted returns like diversified funds also have the lowest gap between time weighted returns and money weighted returns.

So what:

At Darling Macro we use a combination of all 4 techniques to manage equity risk

1. We seek returns away from equity and actively diversify risk with bonds, commodities, precious metals and currencies,
2. We dynamically alter allocations according to changes in risk,
3. We implement option like strategies to protect capital, and
4. We use a rules-based investment process.

The chart shows the value of these techniques by charting a comparison of risk adjusted returns of equities, a balanced blend of equities / bonds and the Darling Macro Index.



ASX200 provides the base case of a 100% strategic allocation to Australian equities, 70:30 blend shows the enhancement from a 30% allocation to Australian bonds, and the Darling Macro Index shows further enhancements.

Note: Returns and risk are shown as since 10/2011 to 10/2020, and calculated based on daily total return indices before fees. The Darling Macro Index is a backtested index based on the Darling Macro investment strategy. The Darling Macro Fund tracks the Darling Macro Index.

Source: Darling Macro, S&P Dow Jones Indices LLC.

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