SOMETIMES I WAKE UP IN THE MIDDLE OF THE NIGHT, THINKING ABOUT STANDARD DEVIATION

In our client reporting, including our Quarterly Investment Reports, we're moving from reporting the various asset classes that make up our clients' portfolios to reporting on what role each piece plays in each portfolio. We believe that this is a necessary and valuable paradigm shift in the way that advisors communicate with clients. This issue of *Quarterly Insights* explains why.

WE'RE FOCUSED ON WHAT KEEPS *YOU* AWAKE AT NIGHT

Here at HH, we talk at length about the benefits of mitigating volatility in portfolios. After all, the ability of a portfolio to compound is reduced by its volatility (and this effect is exacerbated when someone is taking distributions from the portfolio). Understanding and addressing volatility is a fundamental aspect of our profession.

We build portfolios to mute volatility—but we have never once had a potential client tell us, "If you can get my portfolio's standard deviation from 18% down to 14%, you're hired!" It is our job to think in these terms, but we shouldn't bend our clients to think in these terms as well. Our clients tend to think in terms like "growth," "income," "preservation," and "inflation protection." They tell us, "I want growth," or, "I need income," or, "I want protection." They don't say to us, "I want micro-cap," or "I need more REITs," or "I don't have enough fixed income." They lie awake at night wondering if they're getting enough growth from their portfolio in order to meet their retirement spending needs.

Or, they may lie awake worried about how their portfolio will react the next time the Dow drops 300 points. Telling them they have x% in fixed income and x% in multi-strategy does not facilitate important conversations, nor does it do justice to the complexity of the instruments that comprise the whole of their portfolio.

Take the example of the dramatic differences among many bonds. A Verizon bond plays an entirely different role in a portfolio than a reinsurance bond or a baklava bond (sounds delicious, but yes, that's a real thing)—yet they're all labeled in the traditional convention: Fixed Income. To make matters worse, what does *fixed income* even mean to our clients? The income might be fixed, but the principal value can vary considerably.

As with bonds, so it is with every asset class: Individual instruments within each class are selected to take on highly diverse functions. That's why we've pushed for this shift in our reporting format to help you understand what role each instrument is intended to play.

SHOW ME WHAT YOU'RE WORKING WITH

We like to think of ourselves as being fairly innovative for an 84-year-old firm. While we know we're early, we're not the first to start explicitly showing clients the "whys" behind how portfolios are built.

The Alaska Permanent Fund, manager of $57 billion, defines their "Summary of Asset Class Objectives" by the following categories: Capital Appreciation, Inflation Protection, Deflation/Crisis Protection, Capital Preservation, Purchasing Power Preservation, Income Generation, Diversification, and Alpha.

Many of the traditional asset classes overlap across several objectives, such as emerging market bonds serving in both the income-generation and diversification categories. It is a little clumsy, but they've been doing this for a very long time.

As we said, we're early, but we're not alone. As a matter of fact, the very day we approved our final draft of the new reporting format, one of us attended a behavioral finance lecture by a former Chief Investment Officer of one of the largest U.S. financial institutions. He went into great detail about how his new firm reports to clients using a "Desires-based" structure.

Amazingly, we had just spent months working on the new format and here he was, in a room full of analysts, telling them that for 80 years the industry has been doing their clients a disservice by telling them what the assets in the portfolio are, instead of what they're for. To that end, we're hoping our new "roles-based" reporting format will improve our clients' portfolio awareness in intuitive terms—to which they can relate.

NOT ALL FIXED INCOME IS CREATED EQUAL

Here's one example of how we hope this will work in practice: With the first Fed rate hike in the books for 2017 and two more planned, many clients have been asking us what we're doing about rising interest rates in our portfolios.

Using traditional asset allocation, a client might look at her report and see that she's 40% invested in bonds. In a rising rate environment, that could be clear cause for concern. But what the old format doesn't show is that not all "fixed income" is created equal.

Some fixed income behaves like stocks (i.e., high-yield) and will therefore be more sensitive to the pace of economic growth (or contraction). Some fixed income is less impacted by U.S. policy and outcomes and driven more by global currency differentials and relative yield-spreads (i.e., emerging-market debt).

Further, some fixed income has nothing to do with the economy or inflation or interest rates (reinsurance), while other fixed income is a play on the expanding niche of higher-yielding institutional-to-peer loans (i.e., alternative lending). Bottom line, the old format would lump all these characteristics into a single label, "fixed income," which, at a cursory level, would give no indication of the inflation and interest-rate protection we've been building into our clients' portfolios for the past several years.

The new reporting format will break these holdings into different slices, with your most interest-rate sensitive, plain vanilla, investment-grade, U.S. corporate and municipal bonds listed as "Core Bonds." These serve as the ballast when the seas get rocky and they play a necessary role in each portfolio. But if you want to talk about rates , the various techniques described above are delineated in their own categories—defined by their roles in the overall portfolio strategy.

CLIENT-CENTRIC REPORTING

These are the broad categories we're using: Global Equity, Real Assets, Return-seeking Fixed Income, Variance Risk Premium, Tactical Allocation, Crisis Alpha, Low Correlation Returns, and Core Bond. Now we can better address what keeps you up at night.

Are you concerned about inflation? Well, let's talk about that Real Assets category. Are you worried about a stock market correction? Let's talk about Core Bonds, Crisis Alpha, Tactical Allocation, and Low Correlation Returns.

Do you worry about volatility in the markets? So do we. That's what we discussed in *The Cat vs. the Washing Machine* last quarter. Now we can point to all the pieces in your portfolio that benefit from volatility, aka the Variance Risk Premium category.

Like the (not-yet-implemented and now-threatened) Department of Labor Fiduciary Rule, we believe that roles-based reporting is just one more step towards making our industry more client-centric.

The investment management industry has been too opaque, too obtuse, and too oblique for too long and the reality is that it doesn't need to be. We are in the process of developing additional tools and techniques to further this cause and this new reporting format is just one of them.

We're not going to change the world here at HH, but we believe this innovation and others are going to help us have better conversations with our clients. Portfolio discussions should be driven by your goals as a client: your needs, your wants, your dreams, your fears. These conversations should be driven by the dynamic between both your capacity and your willingness to take risk.

They should not be driven by the news du jour on CNBC and the Dow's latest moves. The Dow doesn't know who you are. The Dow doesn't care that you want to own a second home on Lake Tahoe, or that you want to support your grandchildren's education.

A "JOB" WE EMBRACE

It is our job to worry about non-static covariance matrices (*how correlations among assets change over time*). It is our job to worry about maximizing the volatility pumping effect (*the additional return obtained from rebalancing*). It is our job to worry about how to compensate for the fact that the first and third moments of asset pricing cannot be estimated (*expected return and skewness*).

It is our job so that you don't have to worry about these things. And that's why sometimes we wake up in the middle of the night, thinking about standard deviation. Because it's our job.
Not yours.