PORTFOLIO RISK EXPOSURES AS A BED OF NAILS: MOVING BEYOND HISTORICAL DIVERSIFICATION TOOLS

Nearly 2000 years ago, this was written in the Talmud, "One should invest a third of his money in land, a third in merchandise, and leave a third in coins."

This may be the oldest surviving reference to portfolio construction. Today, many investors follow a similar allocation path, including some basic combination of real estate (typically tied up in a primary residence), stocks, bonds, and cash.

But long-persisting correlations among these asset classes are shifting. We believe that our clients' portfolios can benefit from a wider range of exposures and techniques than these traditional diversification instruments. That's the theme of this quarter's letter. Achieving long-term growth is critical. But we can't afford to turn a blind eye to the fact that short-term volatility may derail a client's ability to enable the long-term to play out. That's why we place so much focus on both convergent and divergent strategies (discussed in our April 2016 letter)—along with harvesting multifaceted sources of return, also known as risk premia.

Risk premia are risk exposures that can enhance portfolio performance. We'll drill down more deeply into examples of the risk premia we're currently utilizing in client portfolios, but first, a brief discussion of why we believe they add value in today's investment environment.

BUILDING A PORTFOLIO THAT CAN WEATHER ALL MARKET ENVIRONMENTS—INCLUDING EVOLVING ASSET CLASS RELATIONSHIPS

Thoughtful construction of a portfolio should have many outcomes in mind: *What happens to my portfolio when the economy slows down or goes into recession? What happens if the economy strengthens? What effect will inflation have on my ability to retire? How do I protect my portfolio from the unthinkable? It should also include a healthy dose of What if I'm wrong?*

Traditional stock and bond portfolios have done an admirable job of managing all of the issues mentioned above. In anticipation of a full-blown recession, your stocks may be hammered, but your bonds should hang in there—as long as they're not of the high-yield variety. During a booming economy, stocks frequently do so well that many wish they held no bonds. Stocks can help offset the impact of an inflationary environment, but your bond's income will be less valuable in relative terms and thus the bond itself will become less valuable.

Historically, this "two-party" system has been an effective way of producing positive returns while mitigating downside risk. These two assets have been used together given their low-to-negative correlations with each other. But as we look at the last 100 years, it appears that this relationship may be wearing out. Since the turn of the 21st century, the correlation between U.S. stocks and bonds has risen such that only the longest-term and highest-quality fixed income assets provide safety in a "risk-off" environment.

In addition, the pace at which news crosses the globe has increased exponentially in recent decades. This has a direct impact on investor behavior and enhances a herd mentality whereby market extremes are made, well, more extreme. A review of broad market correlations since the late 90s shows increased relationships between and within major asset classes. This is not to suggest that low or negative (and thus diversifying) correlations do not exist. But these desired diversifying characteristics are waning. And in our low interest-rate environment, the traditional sources of risk protection (e.g., "risk free" U.S. Treasuries) are also virtually "return free."

RISK PREMIA: ACHIEVING TRULY INDEPENDENT RISK EXPOSURES

Investors are compensated for taking on risk, and they will likely benefit from strategies that offer a low correlation with more traditional portfolio assets during times of stress. Risk premia strategies extend across asset classes and formally include factors like size (small vs. big), momentum, illiquidity, and value. We would like to add to this list the concept of an access (or novelty) premium: The diversification benefit and additional source of return arise from an investor's ability to access a specific marketplace, asset class, or investment strategy that's not widely followed by the market.

Here's an example:
In previous quarterly letters we've reviewed some basic reasons why we like reinsurance, primarily the fact that these assets march to the beat of Mother Nature's drum, and not Janet Yellen's (like traditional fixed income securities do). But we also consider this space compelling because it's not a commonly owned asset class.

True, reinsurance has been discussed on the front page of The Wall Street Journal and is garnering significant interest from investors given its characteristics (not least its high yields). But the reinsurance marketplace still occupies a fraction of the fixed income market as a whole, and is still too small to attract the "Big Box" product placement investment firms. This may not always be the case, but we're happy to earn additional returns while the financial world tries to figure out how to broaden its popularity beyond the novelty.

PEER-TO-PEER LENDING: TAKING ADVANTAGE OF THE "ACCESS" PREMIUM

Another avenue of sourcing diversification and returns is from alternative lending, also called social lending or peer-to-peer (P2P) lending. Through the use of technology, lenders can be matched to borrowers without a banking intermediary. Recent trends in the financial industry show that banks are exiting traditional lending for small loans; this space has grown rapidly over the last five years to fill the void.

Given that a bank's costs are relatively the same for a small loan relative to a large loan, and they earn more on large loans, banks devote resources to the more profitable of the two. This is especially important in a world of low interest rates. Online P2P lenders have been able to reduce the costs of regulatory overhead, customer acquisition, underwriting, origination, and servicing—all while avoiding the need for reserve requirements or costs for physical branches. Diversification among many, many loans, rather than reserve capital, is the primary risk control device.

Although the first platforms pursued a pure P2P model, institutional capital gradually emerged as the preferred source of capital. Today it has become the predominant source of funding for alternative loans. This arena is still novel and, in our opinion, can provide not only the higher yield of the underlying assets, but a novelty premium—given the difficulty for retail investors to access it (we call this an "access" premium).

There are many P2P lenders in business today; for illustrative purposes, let's dive into one: Social Finance, Inc., more commonly known as SoFi.

SoFi provides student loans, but more specifically, student loans only to graduates of top schools who have already landed solid jobs with top employers. An example would be a Harvard graduate landing a job at McKinsey. The FICO score of the average SoFi borrower is 730; 79% of borrowers have FICO scores above 700. Their average income is over $120,000 and 15% of borrowers have incomes above $200,000. In addition, 77% own their home, and 27% have a graduate degree (most commonly a MBA, JD, or a graduate degree in engineering).

The risk of default under these circumstances? As you can imagine, it's incredibly low. In fact, of the more than $8 billion in student loans that SoFi originated through July 2016, only 38 individual borrowers have defaulted. SoFi is, in essence, in the super-prime student loan business.

With loan originators like SoFi and others, P2P lending is providing access to a new fixed income market. And while some risks are similar, like default, the structures of these loans are very different from traditional corporate bonds. Many of these P2P loans have a 3-5 year maturity length and are self-amortizing, like a mortgage, which makes them relatively immune to movements in interest rates. There will be no capital appreciation if rates were to fall, but considering where rates are now, we're more than happy to take that trade-off.

There are very few fixed income instruments that possess these properties, and both P2P lending and reinsurance have allowed us to not only remove some of the interest rate risk from our portfolios, but to increase the yield—two attributes that are intertwined, in that you can't typically have one without the other.

HAND IN HAND WITH OUR OBJECTIVE OF ENHANCED RISK AND YIELD CHARACTERISTICS:

ONGOING PEACE OF MIND

The work of Markowitz (1952), who developed basic portfolio theory, described a linear relationship between risk and return. More recent market outcomes suggest that through the harvesting of multiple risk premia, a nonlinear relationship may result. In other words, we believe that we're able to add an incremental return without adding an equivalent amount of risk to the portfolio. By spreading the risk out across these risk premia, our client portfolios are less susceptible to any one risk having a disastrous impact on these portfolios as a whole.

You can liken the risk posed by every available investment asset class or category to a nail: Stepping on one nail can puncture both your shoe and your foot, and inflict a tremendous amount of damage. However, if you lie down on a bed of nails, you spread your weight across many sources of potential damage, but not one of them bears enough pressure to puncture your skin.

Over the course of upcoming newsletters, we'll discuss these "nails" in more detail to help you gain a deeper understanding of our philosophy and process. Beyond helping you achieve your financial goals, we want you to feel confident in the way we assemble portfolios to help you get there.