CLIENT-CENTRIC INVESTING:
UTILIZING A TACTICAL APPROACH TO EXPAND THE FIXED INCOME UNIVERSE

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Macro Thesis

At RPg, we have always defined risk as how much an investor is willing to lose in a short period of time (maximum drawdown) before they are unwilling to stick with their long-term plan. Moreover, we think the biggest risk facing investors is not the short term volatility of returns, but the risk of an investor outliving their wealth. With extremely low interest rates globally, we expect the next twenty years will likely see rates rising. This is a problem for investors, since rising rates are bad for total returns on fixed income.

More specifically, we believe there is the potential for dramatic interest rate changes amidst diminishing global quantitative easing and increasing uncertainty around fiscal and economic policy initiatives. A prudent defense is to employ a diversified tactical approach to the fixed income allocation of investors' portfolios.

As policy "normalization" continues, central banks around the world are likely to communicate a reduction to their reinvestments and the size of their balance sheets. Improving economic data and profits have supported this thesis and have reignited prospects for stronger global growth, higher inflation and potentially a faster pace of interest-rate increases.

Most portfolios are allocated to traditional stocks and bonds as the industry has promoted simplicity and convenience to stay "vanilla". This leads to a reliance on stocks for all future returns, and traditional bonds for the diversification. The reality is that stocks and bonds are small parts of the investable universe which opens the door for a tactical investor who can access many other sources of income and returns which may significantly improve the risk/return characteristics of advisors portfolios.

RPg accesses everything from niche asset classes, to generating returns by exploiting behavioral biases, to the massive exposures hidden in financial institution balance sheets. This expertise and diversification will help advisors keep clients on a successful glidepath within their investment portfolios.

RPg asset management
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Diversification

We recognize that most investors have been diversifying into other types of alternatives within stocks and bonds, but we view that as only being helpful on the margin. Not only are these allocations generally small, but the correlations of these investments generally rise precisely when you don't want them to… During market dislocations.

We have clearly presented expectations of a rising interest rate environment over the next 20+ years, however, we do not expect the path will be linear. There are many other factors such as the timing, size, and composition of future fiscal and monetary initiatives which we believe will present both risks and opportunities. A prudent defense will need to include the following characteristics:

- Liquidity
- Bi-directional investment strategy
- High degree of flexibility (tactical approach to income generation)
- Tenured experience
- A dynamic approach to risk management

Blueprint for a tactical approach to income generative investments

All managers need a "blueprint" for how to build a diverse, income generative portfolio. The tactical income portfolio can be dramatically better than the traditional fixed income portfolio following three simple guidelines:

1. All investments should be able to "pull their own weight" in the portfolio and offer a sufficient return.
2. Diversification – The only free lunch in town – Including investments that can contribute to consistent returns, and/or protect against the downside requires a wide range of investments with diverse return drivers.
3. Liquidity is king – Even if it means employing cash during times of stress in the capital markets. With future capital markets returns expected to be subdued from these levels, illiquidity may present a "tax".

Expected Returns Above Risk-Free Rate

Asset Class	Gross-of-Fee	Net-of-Fee	Source
US Gvt Bonds	0.35%	0.25%	JP Morgan
US Corporate Bonds	1.85%	1.25%	JP Morgan
US Equities	5.00%	4.25%	JP Morgan
"Better Beta"	5.80%	5.05%	Bloomberg, JPM
Private Equity	8.00%	6.00%	JP Morgan

Following these rules will lead investors down a different, more diversified, and arguable better path for their fixed income portfolio. Following Rule #1 supports the tactical approach as portfolios will need to find investments that generate enough income that they can mitigate some of the expected volatility we expect from fixed income markets. With the expected returns from US Government and Corporate bonds so low and risk profiles so unfavorable (low upside, large potential downside) they barely make sense to own. It appears to make sense to tactically seek a more diverse set of opportunities.

Following Rule #2 will demand a flexible mandate to the asset allocation. This implies an allowance of equity investments that can generate significant yields and having a tactical approach to those investments. Following this Rule may improve the income level and provide a more durable income stream.

Following Rule #3 will lead to a liquid, bi-directional (credit, rates, spread), and tactical approach to portfolio construction. This process will lead to greater yield generation in a more diversified, risk-managed, process oriented portfolio.

A Tactical Approach

Tactical investing can involve qualitative and quantitative models that are used in an effort to remove cognitive biases that enter the investment decision making process, limit losses, and reduce volatility. Many strategies look and sound logical and have mass appeal especially at times when investors have fresh memories of significant market declines and multi-year bear markets that decimated portfolio values. This happens with fresh memories of generally positive returns as well and can be misleading when making investment decisions. We have written about this in the past and we refer to this condition as “present bias”.

This “present bias” happens when we feel more compelled by the data that is in front of us now than by what is coming in the future. Employing a rules-based, tactical investment methodology for a portion of an investor’s fixed income portfolio can help remove the “present bias”, and may help keep investors on their long-term glide path with more durable income streams.

By employing financial and cognitive diversity within an income generative portfolio, Investors may have a higher likelihood of enjoying the benefits the tactical space works so hard to deliver; a systematic approach to increase income, reduce volatility, and loss avoidance.

Conclusion

These thought processes bring up several points to consider when building a tactical component to an income generative allocation. First is asking the right question about an investor's biggest risks and building out from that point. We think it is essential to start with a needs-based solution focused on minimizing a shortfall of wealth in retirement. This process should have the flexibility to adjust as an investors needs change and/or asset valuations change. At RPg, we think a tactical approach can provide an objective way of seeking to avoid such a shortfall, and can be highly customizable in a way that seeks to solve the right challenge.

Second, we think employing a tactical approach during the accumulation phase and distribution phase is essential in helping investors stay on their necessary glide path seeking to preserve wealth through retirement. By tapping into a collection of intelligence we think investors will come to better conclusions in their fixed income portfolios which in turn should produce better outcomes.

Third, is the alignment of interests. If we define risk in a way that the investor does, and that has an effect of compressing volatility and providing a more durable yield in their portfolios, we think there is a positive chain reaction that begins with a better investment eco-system for the investor.

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