Flexible Plan Investments, Ltd.
Your partner in active wealth management since 1981

Why now's the time to rethink your risk-management strategy

As Jerry Wagner, president and founder of Flexible Plan Investments, often says, "Risk is always with us." But when the next "super bear market" rears its ugly head, will the risk-management strategies your clients have in place be enough?

Is time really on your clients' side?

Over the history of the U.S. stock market, given a long enough period of time, equity investors have been rewarded with growth in their portfolios. But they have also faced periods of extreme volatility and steep drawdowns for those same portfolios.

It is entirely conceivable that this decade will not see a market correction of more than 20%. So far, the S&P 500 has tested the commonly held definition of a bear market three times in the 2010s, with three corrections showing declines greater than 15%, but not greater than 20%, on a closing price basis.

Market history argues that this is a fairly rare occurrence for any market decade.

As the following chart shows, every decade since 1920, with the exception of the 1990s, has had at least one market decline over 20%. Most of those declines were much worse.

Bear Market	Duration in months	% of decline	Years needed to break even
Sept '29–June '32	33	86.7	25.2
July '33–Mar '35	20	33.9	2.3
Mar '37–Mar '38	12	54.5	8.8
Nov '38–Apr '42	41	45.8	6.4
May '46–Mar '48	22	28.1	4.1
Aug '56–Oct '57	14	21.6	2.1
Dec '61–June '62	6	28.0	1.8
Feb '66–Oct '66	8	22.2	1.4
Nov '68–May '70	18	36.1	3.3
Jan '73–Oct '74	21	48.2	7.6
Nov '80–Aug '82	21	27.1	2.1
Aug '87–Dec '87	4	33.5	1.9
July '90–Oct '90	3	19.9	0.6
Mar '00–Oct '02	31	49.2	4.7
Oct '07–Mar '09	17	56.8	3.0

Source: Flexible Plan Investments, Ltd.

Can your clients afford to "ride out the storm"?

While one can argue that market declines are eventually resolved in favor of new highs, that can take many years—and a whole host of issues arise when portfolios are down 30%, 40%, and 50-plus%. For those who have adopted a passive investment stance and standard portfolio allocations, not only does it take emotional fortitude to "ride out the storm," many investors just do not have the time to do so. This is especially true for investors near "the retirement red zone," within five years of either side of retirement. Here, the issue of sequence of returns can have a devastating effect on a retirement-income plan that has some dependency on risk assets.

One of the major issues is the simple fact that the passive core portfolio allocations of the past, many based on modern portfolio theory (MPT), have not provided adequate protection during severe market downturns.

In his book "The Indomitable Investor: Why a Few Succeed in the Stock Market When Everyone Else Fails," author Steven Sears, a Barron's columnist, wrote, "The black swan always hovers over the market's horizon. … Wall Street's most accomplished practitioners see a future filled with tail risk. If something happens that history has not anticipated, Modern Portfolio Theory breaks down."

A key underlying theoretical premise of MPT, the efficient frontier, is examined in detail in an article in Proactive Advisor Magazine, "The Efficient Frontier Fails the Test of Time." The article outlines multiple issues with efficient frontier theory, concluding,

> "It is time to rethink the efficient frontier to accommodate new investment approaches to achieve reduced risk and improved returns. … By developing allocations based on market conditions and incorporating the use of strategic diversification, today's active managers can manage risk while dynamically optimizing portfolio allocations. This is where a total portfolio approach to active management comes into play."

When basic risk management isn't enough

Flexible Plan Investments has taken on this challenge directly, recently introducing a turnkey Multi-Strategy Core solution for our adviser and investor clients.

Our Multi-Strategy Core portfolios are composed of a blend of risk-managed core strategies designed to be robust to changing market conditions and are available in five suitability profiles. These portfolios go beyond the basics of modern portfolio theory, the efficient frontier, and traditional asset allocation to provide three levels of risk management:

1. Everything starts with a universe of risk-managed mutual funds.

2. Flexible Plan's QFC strategies actively allocate among the mutual funds to employ each strategy's methodologies. Each of these strategies employs methodologies judged best to contend with volatility and deliver superior risk-adjusted returns—and because they are subadvised by Flexible Plan, the strategies provide credits to offset advisory fees.

3. Multi-Strategy Core allocates among the QFC strategies in managing each portfolio.

The Multi-Strategy Core solution provides several benefits versus traditional core strategies:

- The flexibility to use multiple asset classes, sectors, and alternatives.

- A rules-based methodology, taking emotion out of the investment equation.
- The use of both strategic and tactical core investments.
- The ability to dynamically adjust portfolio market exposure, depending on market conditions.
- A goal of seeking both risk mitigation and highly competitive returns.

Multi-Strategy Core can be used several ways:

- As a stand-alone risk-managed core strategy.
- As a tactical, risk-managed addition to a passive, strategically allocated core strategy.
- To add diversification and risk management to an existing portfolio.

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The rules for portfolio growth and diversification have changed. Portfolio construction theory that is mired in the practices of the past may not be enough to face today's complex and ever-changing market. In a series of informative articles written in 2019, Jerry Wagner, president and founder of Flexible Plan Investments, outlines his views on the nature of risk and its mitigation, which are foundational to creating today's best practices in modern portfolio construction.

Using an Apollo innovation in your investing

Although nowhere near the grand scope of the space program, each time we launch a client's portfolio we realize that it, too, is taking off into the unknown. To be successful, it needs to be able to withstand a future containing the challenges of many different market environments. To do this, we discovered, like the Apollo engineers, that different vehicles must be present in the portfolios to reach our goal. No single strategy can fully prepare us for the unexpected.

Read more

Building stronger portfolios from the bottom up

Creating an investment portfolio is a bottom-up process that begins with accessing asset-class returns, the benefits of true diversification, and dynamic risk management. If we combine these basics, we can achieve our goal of building portfolios that participate in asset-class returns while also providing protection against risk. Read more

Risk is always with us

We must remember that risk is real and that, like death and taxes, it is always with us. Dynamic risk management can help investors deal with the three different types of risk to their investment portfolios: unavoidable risk, probable risk, and improbable risk. Read more

Lessons of an "unsuccessful" wall

When the line between two types of market corrections is crossed, and the correction turns into a bear market, do your clients really want to have just one investment strategy with which to protect themselves? Read more

Investing can be a turnkey experience

Turnkey solutions provide a superior user experience. They are designed to be easier to walk into and a better way to cruise throughout all of the varied seas the financial markets can deliver to bring us to new lands of opportunity.

Read more

Investing—going beyond "halfway to anywhere"

Investing in a core portfolio is key to achieving your investment goals. But the explore part of your portfolio can take you from there to anywhere you desire.

Read more

Sources

1. Steven M. Sears, "The Indomitable Investor: Why a Few Succeed in the Stock Market When Everyone Else Fails," Wiley, 2012, https://www.amazon.com/Indomitable-Investor-Succeed-Market-Everyone/dp/111811034X

2. Linda Ferentchak, "The Efficient Frontier Fails the Test OF Time," Proactive Advisor Magazine, March 6, 2019, http://proactiveadvisormagazine.com/the-efficient-frontier-fails-the-test-of-time/