VAN LIEW TRUST COMPANY

as we see it

Fall 2020

THOUGHTS FROM OUR CHAIRMAN

Our country faces significant challenges. In addition to a pandemic, politics are more divisive than ever, making it harder to see the common objectives of what unites us rather than what divides us. The ultimate casualties could be both capitalism and our Constitution as we know it. Trade and peace treaties are also at issue. Having served the US well since the '40s and '50s, we have neglected them in more recent times. Now, efforts to address the problem are met with pushback and new challenges as people and nations resist proposed change.

Opening the door to China was once hugely important to the USA regarding trade and access to lower cost manufacturing. Now, as China approaches the status of a dominating world power we see the cost of such earlier decisions and are resisting further Chinese efforts. Perhaps a traditional approach to hold China at bay would be to join a coalition of allies, but to date the US goes it alone. More challenges it seems, and for investors, a volatile environment.

Our associate, James Powell, in this Fall issue of As We See It reviews our diversification process for dealing with volatility.

Alfred B. Van Liew

Risk Management: Building a Strong Foundation

James M. Powell, CFA, CAIA

"What gets us into trouble is not what we don't know. It's what we know for sure that just ain't so." - Mark Twain

In the spring of 2019 I wrote an As We See It essay titled "Risk Management 101 (or It's All Greek to Me!)" . My objective with that article – as it is for this one – was to add some perspective about risk to our conversations. A significant point in that article was that "as investors we can really only control the risk side of the coin – *return is only an outcome*." The past year has served to clearly demonstrate that point, so I thought it might help to review how our focus on risk management has played out since that essay.

As we approached the end of 2019, there was some concern that we were late in the business cycle but with relatively little angst in the capital markets. U.S. Large Cap Stocks had returned +31.5% for the year, Investment-Grade Bonds had returned +8.7%, expectations of corporate profits were positive and we were looking for "green shoots" in anticipation of a global economic recovery. For those who followed global events, news about an illness that had taken hold in a region of China raised some eyebrows, but this had happened before and wasn't particularly alarming.

By the end of the first quarter of 2020, U.S. Large Cap Stocks had declined -19.6%, Investment-Grade Bonds had returned +3.1%, the US had experienced the sharpest recession in history and we were watching a world slowly come to terms with a true global pandemic. That was before we even looked at our newspaper headlines or turned on our chosen news channel!

In the second quarter, U.S. Large Cap Stocks bounced back with an eye-popping +20.5% and Investment-Grade Bonds returned +2.9%. We witnessed the shortest bear market in modern history. As we now approach the end of summer, we are trying to make the best decisions we can without very much information in a period of great uncertainty.

In the investment world, we have particular fondness for that leading quote from Mark Twain. There are myriad financial studies showing how difficult it is to time the markets and we are not trying to prove them wrong. However, several important functions of ours include identifying and preparing for a number of scenarios that can unfold and creating options to capitalize on opportunities as they arise.

We prepare for uncertainty and mitigate the damaging effects of volatility by continuously diversifying risks at multiple levels. The single largest determinant of portfolio performance is how an account is invested between stocks, bonds and cash. In fact, about 90% of the variance in returns is explained at this level, so the Strategic Asset Allocation ("SAA") – the long-term mix of stocks, bonds, and cash – is very important. * We regularly rebalance accounts between these three asset classes because history shows they perform independently of each other in different market scenarios. There may be times when we stray from that SAA on a short-term basis to either add or remove specific risks (i.e., equity risk, interest rate risk, default risk, etc.) given what we observe and discuss in our Investment Committee meetings, but over the long term we will stick to that SAA, only changing it in consultation with our customers.

The second level of diversification occurs just one step down, as we diversify the equity and fixed income portions of the investments into different sectors. We divide the universe of stocks into eleven different sectors and which customers find listed in their account statement, where they will find the sector allocation specific to the equities in their account, our Investment Committee recommendation and the sector allocation of the S&P 500. Each sector has its own patterns of behavior as capital market expectations change. For example, consider how differently energy companies have performed this year relative to technology companies.

We do the same for fixed income allocations, dividing the universe of fixed income first into Core and Satellite positions, each of those two groups comprising four different sectors and based on our observations of what is happening in the macroeconomic environment. For example, short-term investment-grade bonds are safe but won't earn very much yield; high-yield bonds may be risky but can earn a higher yield. We are looking for an optimal risk-adjusted return (which is a topic for another day).

A third level of diversification for equities is dividing each of the sectors into their component industry groups. For example, the Industrials sector alone comprises 17 different groups including seemingly disparate groups such as Aerospace & Defense and Human Resource & Employment Services. For fixed income, it is across time and credit quality, each with its own unique risks and rewards. We continue this process until we get to the individual security level.

I hope this broad outline has shed some light on how we apply the principles of diversification to mitigate the harmful effects of volatility and prepare for different scenarios in periods of uncertainty. To an investment professional, they are all periods of uncertainty, and again: "as investors we can really only control the risk side of the coin – *return is only an outcome*."

* Gary P. Brinson, L. Randolph Hood & Gilbert L. Beebower (1986) Determinants of Portfolio Performance, Financial Analysts Journal, 42:4, 39-44, DOI: 10.2469/faj.v42.n4.39