Defensive Strategies Aren’t Always Bearish

SYNOPSIS
- The Investment Committee has recently become more defensive in the DIAS portfolios in order to shield from risks associated with a rise in volatility.
- Although it is impossible to determine if a market correction has already begun, we welcome any selloff in the face of positive economic data and stand ready to buy securities that go on sale.
- Market timing does not work, and those who have been waiting for a correction as an entry point have watched equities rise over 35% in the last 18 months with nothing to show for it.

WE ARE EARLY OFTEN
A key component to the DIAS philosophy is to “go anywhere” to seek profits. We do not lock ourselves into a specific style like the way most mutual funds are marketed. For example, our Conservative Income (CI) portfolio is not a bond fund, a large-cap equity fund, or even a 70/30 blended fund.

Rather, it is designed to achieve a dual mandate consisting of (1) Preserving capital, and (2) Delivering a risk-adjusted income stream only after the first goal is achieved. Therefore, the Investment Committee will often make decisions that dramatically impact asset allocation in order to either lock in gains or avoid future risk.

NOTE: CI is not constrained to stay fully invested, which was one of the many reasons the portfolio performed so well during the worst financial crisis since the Great Depression. Most mutual funds are mandated to hold less than 1-2% cash, so they were forced to find areas in the market to hide out and endure big losses back in 2008.

Back in late 2013, the Investment Committee sold a group of stocks that we felt were too expensive given their future growth prospects. The decision was predicated upon a risk appraisal indicating that although there may be additional upside remaining, the downside was far greater, and subsequently we moved to cash.

Many of the stocks that were sold continued to rise through the first half of 2014, until just recently when they ultimately cracked and have been under selling pressure since. Had we remained invested in these stocks until the moment they reversed course, there’s no question that we would have likely achieved higher returns for our investors.

However, we pride ourselves as risk managers, not risk takers, and our investment strategy is one where we aim for singles and doubles. As exciting as it is to swing for homeruns from time to time, we are not willing to expose our income-focused portfolios to the volatility associated with striking out.
As a result, we conduct thorough risk assessments on each of our holdings on an ongoing basis. When we determine that the potential downside outweighs any remaining upside, we typically sell. Admittedly, this strategy will occasionally result in selling too early, as it did in the example above, but given that it’s impossible to time a shift in sentiment, we would rather be early than risk being late.

**NOTE:** It’s often tempting to over-allocate a portfolio towards “home run” style investments after years of healthy gains, as we’ve seen in equities since 2009. Just remember that although risk can pay investors quite handsomely, it can also make investors pay dearly, as it did in 2008.

Simply put, our investment style will often force us to sell early and potentially leave money on the table, because we are not willing to expose the portfolios to the downside as a security price rises above a risk threshold.

**RECENT MOVES ARE CONSISTENT**
The DIAS portfolios have utilized the high-yield (a.k.a. “junk”) sector within the bond market to generate attractive risk-adjusted income for many years. This class of bonds is issued by companies with less than perfect credit and pays a yield that is higher than those firms with top-tier credit to compensate investors for the added default risk.

Our investment thesis for this subsector was based on the fact that Fed policy has forced investors to pile into riskier asset classes to find yield, and as interest rates began rising, the default risk inherent in these bonds would fall as a direct result of a stronger overall economy. Therefore, we could collect attractive risk-adjusted yield in the face of rising interest rates.

Over time, this strategy caught on with other investors, and until recently these bonds performed very well. However, just as equities can become overvalued due to their price rising too fast, these bonds also realized strong price appreciation as investors turned high yield bonds into a “crowded trade.”

Therefore, the Investment Committee made the decision last week to begin selling these bonds in our investors’ portfolios. In doing so, the DIAS Conservative Income (CI) portfolio has gone from 13% cash up to 30%, and the DIAS Conservative Income with Growth (CIwG) has increased from around 9% up to 13%.

**NOTE:** The discrepancy in cash is due to CI’s goal of pure income generation vs. CIwG’s goal of less income and more growth exposure. Since the bonds that were sold are used primarily for income, we held a higher percentage in CI vs. CIwG.

Simply put, we sell any and all asset classes when we believe that the risk to the downside outweighs the remaining potential for upside, even if it increases our cash to abnormally high levels. When we elevate cash balances for short-term (a.k.a. “tactical”) reasons, keep in mind that it does not mean that our long-term thesis has changed. We continue to remain bullish and plan to redeploy this cash in a disciplined manner when opportunity arises.

One way that we may actually deploy this cash is by repurchasing the same high yield debt, given that our fundamental thesis remains intact. According to Moody’s, the default rate for high yield bonds is currently at an impressive 1.9% vs. the long-run average of 4.5%.

As the economy continues to grow, these firm’s revenues should also rise, which means that they should have an easier time paying their debt since more money is coming in the door. Low default risk and high yields do well in a rising interest rate environment.

Therefore, if this subsector continues to sell off to a level that becomes more attractive to us, we will strongly consider rebuilding these positions. Until then, we will remain on the sidelines and look for opportunity elsewhere.
CORRECTION TALK CONTINUES
The Investment Committee’s most recent quarterly report discussed the possibility of volatility returning to the market by the end of the summer. Our thesis was predicated upon two key developments during the second half of the year.

The first was the potential for political uncertainty from the midterm election, and the second was trader panic resulting from the end of Quantitative Easing (QE) in October, which is the tool that the Fed has used to keep interest rates artificially low.

It appears that our prediction is now playing out as we’ve seen investor concern rise over the past few weeks due to QE ending. In fact, this volatility spike is one of the reasons that the Investment Committee made the decision to exit high-yield bonds.

As expected, this rise in volatility has also reignited discussions of a possible equity correction looming on the horizon. A correction on Wall Street is defined to be a short-lived downturn in the overall equity market greater than 10%.

NOTE: Although the notion of a large drop in equity prices may sound alarming, corrections are healthy components to bull markets and are almost always wonderful buying opportunities for long-term investors.

This volatility has spooked so many short-term traders, market pundits in the media, and those investors sitting on the sidelines because we have not experienced a correction since 2011. History shows us that a correction typically occurs about once every 18 months, so the logic floating around circles on Wall Street is that since we haven’t seen one in a while, we are due for a big one any day now.

The issue with this logic is that timing a correction is impossible, and Wall Street has been preaching about this impending correction for close to a year now. The noise about a correction has gotten so loud at points that the market has nearly talked itself into one several times since January, despite a lack of any legitimate catalysts.

However, if this recent volatility is enough to ultimately correct the equity market, the Investment Committee will welcome it with open arms for three key reasons:

1. **Economic Data**: The data continue to be overwhelmingly positive, pointing to a strong GDP recovery in the second quarter, a shrinking deficit, lower unemployment, and continued strength in consumer confidence. Equities that sell off in the face of positive economic data allow patient investors to profit from the fear and panic of others.

2. **Dry Powder**: Our recent allocation changes have raised cash levels, and it’s always better to go discount shopping with more cash. Hence, we are excited at the prospects of deploying cash on “stupid cheap” securities if and when they emerge.

3. **Focus on What Matters**: Corrections are short-lived, and we would be encouraged to see focus shift back towards the slow and steady rise in our economy and corporate earnings.

Simply put, our recent asset allocation shift to cash will be very well timed if we do actually see a correction over the coming weeks. If one does not occur, we will maintain our philosophy of waiting for opportunity to come to us instead of chasing it.

IS NOW A GOOD TIME TO BUY?
There is no doubt that the most frequent question for the Investment Committee from its investors is if now is a good time to be buying equities.
It’s pretty obvious that any rational investor seeks the best deal possible for an investment. Nobody, including the Investment Committee, wants to purchase a stock and then watch it fall 10% before it begins its gradual climb up over the next two years as a thesis plays out.

However, timing entry points is extremely difficult and those who have been waiting for a correction to buy in on a dip have been forced to watch the market do nothing but climb higher over the past three years.

Some basic math is all it takes to see why poor timing in a secular bull market can still return very attractive results. Buying an S&P 500 index fund in...

- June 2013 would have lost an investor 5.6% in a matter of a few weeks. As of August 1 2014, that investor would be up over 15.6% with 2.9% in dividends for a total return of 18.5%.

- Second quarter of 2012 would have lost an investor 9.6% rather quickly. As of August 1 2014, that investor would be up over 36% with 7% in dividends for a total return of around 43%.

- July 2011 would have dealt a brutal blow by declining 18.4% in a matter of weeks. As of August 1 2014, that investor would be up over 42.3% with 10% in dividends for a total return of 52%.

These time periods above represent the three worst possible points to have bought into the S&P 500 since 2010, yet buying at each of these would have still been highly profitable!

Maintain a long-term investment horizon with equities and ignore the hiccups along the way. Bad timing happens but that cannot possibly be predicted with any consistency, so stay invested knowing that our “style” remains that of capital preservation and seeking strong, risk-adjusted returns over the long run.

The bottom line is that we don’t always build large cash balances because our long-term view has changed. We often employ tactical strategies to shield portfolios from risks that arise from time to time. These risks may never play out, but we would much rather be safe than sorry with our investors’ principal.

We remain bullish in equities over the next several years and see very little risk of falling into another recession. Stay invested and keep in mind that volatility in equities is almost always good for long-term investors.

Sincerely,
Mike Sorrentino, CFA
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