Caution Alone is Not an Investment Strategy

There are no easy answers in the financial markets right now because of the run-up we've experienced over the past number of years. The alternative -- lower valuations, higher yields, more bargains, etc. -- is, however, worse because that would mean everyone would have less money in their portfolios. We have to play the hand we're dealt and anyone who tells you with certainty they know how things will work out from here is nuts. Legendary investor Howard Marks gave investors 6 options in an update this summer. In a piece I wrote for Bloomberg, I give the pros and cons of the best options.

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In late July, Oaktree Capital's Howard Marks put out a memo describing current investment trends that could turn out to be mistakes. Marks urged caution on equity valuations, low volatility, FAANG stocks (Facebook, Amazon, Apple, Netflix and Google), ETFs, interest rates, private equity, venture capital and even bitcoin.

Caution alone is not an investment strategy, so Marks penned a follow-up memo last week to give investors six options for how to invest in a low-return world:

1. Invest as you always have and expect your historic returns.
2. Invest as you always have and settle for today's low returns.
3. Reduce risk to prepare for a correction and accept still lower returns.
4. Go to cash at near-zero return and wait for a better environment.
5. Increase risk in pursuit of higher returns.
6. Put more into special niches and special investment managers.

And here's how he would proceed, given today's choices:

As I mentioned above, none of these possibilities is attractive or a sure thing. But there are no others. What would I do? For me the answer lies in combination of numbers 2, 3, and 6.

Investing is never a sure thing because we're all forced to deal with an uncertain future. But today's environment does present investors with few easy decisions. I agree with Marks that numbers 2, 3 and 6 are your best options, so I'm going to run through a list of pros and cons for each.

Invest as you always have and settle for today's low returns.

Pros: Given current valuation and interest rate levels, it makes sense that market returns should be lower going forward. Doing nothing is a decision. The simplest option for most investors is to stick with their long-term investment plans and adjust their expectations. As long as you can keep your costs and expectations in check, there's no reason sticking with a well thought-out strategy shouldn't continue to work.

Cons: If markets are unable do the heavy lifting for a portfolio, investors are going to have to pick up the slack elsewhere and learn to behave enough to earn their fair share of market returns. Lower market returns likely mean people should save more, make more, work longer, spend less or adjust their lifestyle in retirement.

Reduce risk to prepare for a correction and accept still lower-returns.

Pros: Reducing risk can give you valuable dry powder to take advantage of future opportunities. The hope is that you can put money to work at lower valuations or higher yields if and when things eventually go wrong. Cash is a position even if it doesn't pay much in terms of interest income at the moment. Reducing risk offers optionality.

Cons: You could be waiting a long time to put your money back to work, so extreme patience is required. In the latest streak the S&P 500 Index hasn't had a double-digit decline since February 2016. There have been no 5 percent downturns since June 2016. And it's been 10 months since the last 3 percent correction.

Timing the market is also a gateway investment to a cash addiction. There are always good reasons to wait for another buying opportunity. When stocks go up you tell yourself you'll wait for a correction, and when a correction comes you tell yourself you'll wait until they drop just a little further. There are no all-clears when things are going down, so you must incorporate rules to guide your actions. Going to cash also means you have to be right twice -- once when you get out and again when you get back in.

Put more into special niches and special investment managers.

Pros: Niche investments and specialized investment managers can offer uncorrelated return streams, provide downside protection or take an opportunistic approach to the markets. Risk-adjusted outperformance through a unique manager or strategy can add value as a return-enhancer or portfolio diversifier.

Cons: It's tough to find consistent sources of alpha in the markets because of increased competition, high costs and lack of access to the best money managers. Marks is one of the greatest investors of all time, but it's nearly impossible for most of the investing public to invest in his funds as they are reserved mostly for large institutional investors.

Diversification is the idea of reducing specific risk in your portfolio. Looking for special niches or a special investment manager introduces specific risk back into the portfolio. There's nothing wrong with the pursuit of special investment returns, but it should be done in moderation for those who would like to control risk in their portfolio. You can make more money but also lose more as the distribution of returns widens out.

There are no right or wrong answers here, but Marks' idea of combining different strategies seems like a prudent form of risk management. Investing is a form of regret minimization, so a diversification by strategy is an intelligent way to minimize the probability of making the wrong choice.

Originally published on Bloomberg View in 2017. Reprinted with permission. The opinions expressed are those of the author.