Fiduciary Insanity?

Reflecting on the Lasting Impacts of the 2008 Financial Crisis

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The financial press has been awash with articles commemorating the ten-year anniversary of the collapse of Lehman Brothers and the Global Financial Crisis (GFC). Many of these articles have focused on the causes, what should have been done differently, and the risks of another financial catastrophe.

The GFC was the biggest threat to the world's economic system since the Great Depression. Fortunes were lost, lives were ruined, and the current populist upending of the post-World War II order were all results of what transpired a decade ago.

The crisis has had a lasting impact on investor attitudes toward risk. But even so, there are many indications the finance industry and investors are making the same mistakes they made prior to the crisis.

Lasting Impact: More Conservative Investors

Despite the S&P 500 setting record highs, investor concerns have shifted to preserving capital rather than chasing returns. A recent study[1] by Cerulli Associates, summarized by ThinkAdvisor's Emily Zulz[2] and FinancialAdvisor IQ's Garrett Keyes[3], states that investors prefer downside protection to outperformance by roughly a three-to-one margin. While numerous financial professionals are focused on relative performance versus the S&P 500, investors would rather protect what they have than shoot for the moon.

Demographically, those with the highest emphasis on capital preservation are over the age of 60 or under the age of 30. This makes sense. Investors in the 60+ age bracket would have been around 50 during the Global Financial Crisis. Many would have been in their peak earning years and hopefully had a nice nest egg built up in 401(k), IRA, or 403(b) plans. With traditional asset allocation models losing more money during the GFC than the "worst case" scenarios predicted, it is no wonder they are more risk-averse as their retirement draws near.

Meanwhile, Millennial investors under the age of 30 would have come of age during the Global Financial Crisis. Many struggled to find work during the recession and the problem of student debt has been well documented. Roll in distrust of the financial system, and you have a recipe for conservative investors.

Despite these shifts, many of these investors are taking on more risk than they really want to. Baby boomers are making up for the income they're missing from bonds while millennials are being put in more aggressive portfolios because of their age instead of their risk tolerance.

Learning the Hard Way

During and after the Global Financial Crisis, many investors learned the hard way the importance of not losing big. While they might have clawed back their losses over the last decade, 2008 haunts their decisions. With good reason, the last thing they want is to experience something like that again.

This is why they hire a financial advisor: to lessen the impact such catastrophic financial events. So how has this been addressed at the portfolio level?

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[1] The Cerulli Edge – U.S. Retail Investor Edition, 3Q2018

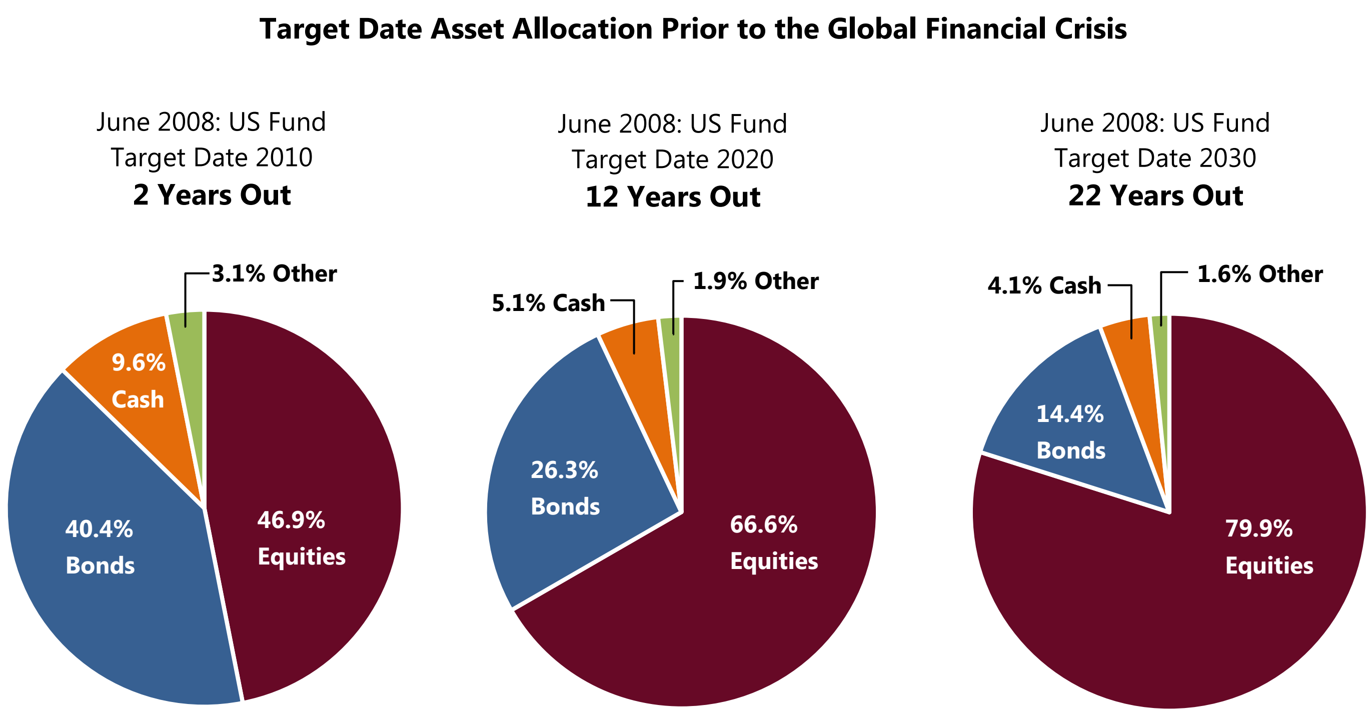
[2] 75% of Investors Prefer Protection Over Profits: Cerulli, Emily Zulz, August 9, 2018

[3] Clients Favor Clients Favor Investment Safety Over Performance … But How do FAs Balance What Clients Want and Need?, Garrett Keyes, August 22, 2018

Failure to Impact: Portfolio Construction and Portfolio Concerns

The shift in investor preferences since the 2008 financial crisis hasn't seemed to reach the portfolio level, however. Many portfolio allocations are very similar to those before the 2008 crisis, and this is a problem because many of the asset allocation models failed to properly protect investors during the crisis.

Using target date funds as a proxy for typical asset allocation portfolios, let's look at how three "vintages" of target date funds were allocated just prior to the GFC in June of 2008. The data below is based on Morningstar category averages.



Source: Morningstar Direct

In 2008, these vintages would have been two, 12, and 22 years away from their target dates. They fall into a typical asset allocation range, with equities and bonds making up the lion's share of the allocation. The more aggressive portfolios have a bias towards equity, the more conservative portfolios are weighted to bonds and cash. This is all standard practice.

Rude Awakening

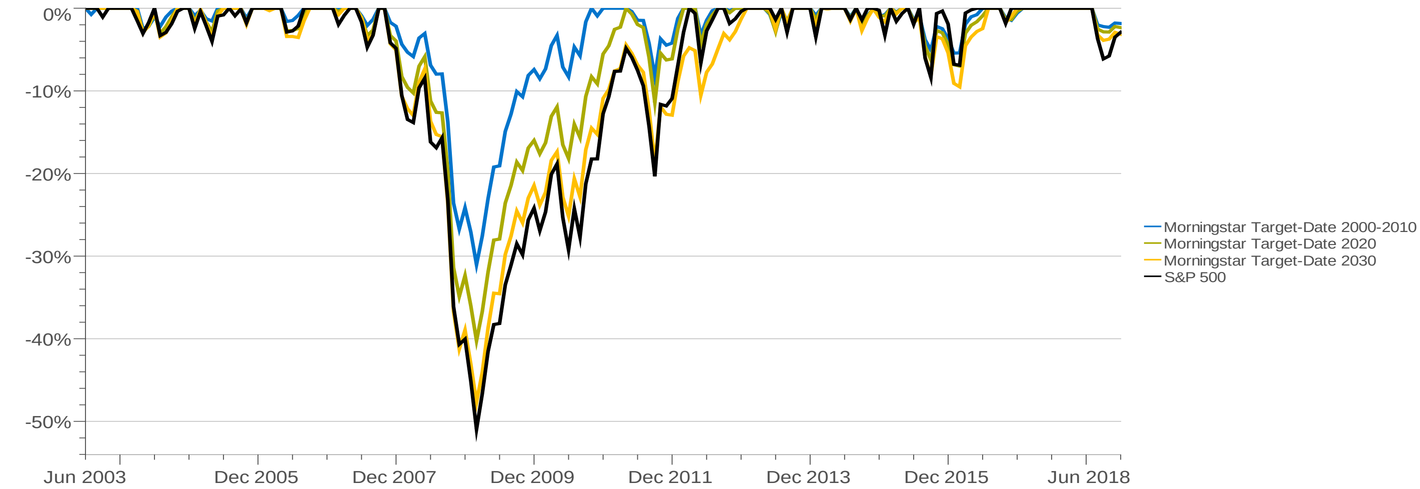
How did these perform during the GFC? The results were quite grim.

Zephyr StyleADVISOR

Zephyr StyleADVISOR: Swan Global Investments, LLC

Drawdown

July 2003 - June 2018



Drawdown Table

July 2003 - June 2018: Summary Statistics

	Max Drawdown	Max Drawdown Begin Date	Max Drawdown End Date	Max Drawdown Length	Max Drawdown Recovery Date	Max Drawdown Recovery Length
Morningstar Target-Date 2000-2010	-31.03%	Nov 2007	Feb 2009	16	Oct 2010	20
Morningstar Target-Date 2020	-40.24%	Nov 2007	Feb 2009	16	Apr 2011	26
Morningstar Target-Date 2030	-47.71%	Nov 2007	Feb 2009	16	Jan 2013	47
S&P 500	-50.95%	Nov 2007	Feb 2009	16	Mar 2012	37

Source: Zephyr StyleADVISOR

The average of the 2000-2010 vintage lost over 31% of their value. In theory, **these target date funds were supposed to be suitable for investors near or in retirement**.

The 2020 vintage lost over 40% and the 2030 vintage's loss of 47.7% almost matched the loss on the S&P 500. It took the average 2000-2010 fund three years to recover its losses from the GFC while the 2030 vintage took over five years.

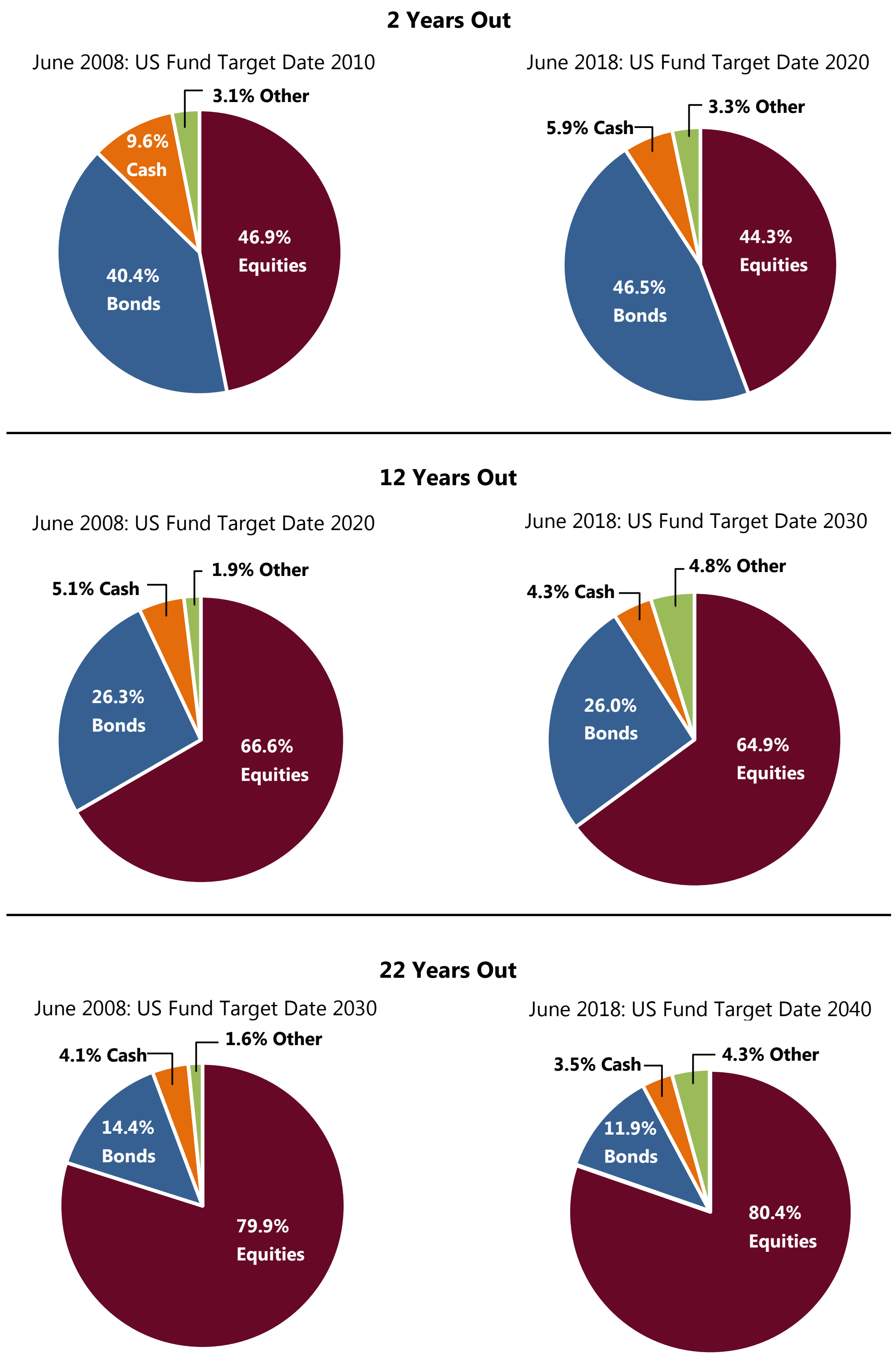
Of course, all of this assumes no money was withdrawn from these investments during the sell-off. If withdrawals were factored in the time to recovery would be lengthened.

With these kinds of results, one would expect significant changes at the portfolio level, especially for conservative investors.

So how have asset allocations changed or evolved in the last ten years?

They haven't, really.

Target Date Asset Allocation Prior to the Global Financial Crisis versus Now



Source: Morningstar Direct

The asset allocations are almost identical.

People may be more risk averse now, but this attitude shift isn't being addressed at the portfolio level.

Investors may have learned the considerable impact of large losses on their lives, but the industry has failed to provide substantial solutions to these concerns.

Alternative Allocations

This is not to say that no one is trying anything different. The Cerulli Associates[4] study also indicates that financial advisors are adding more alternatives into their portfolios. As Emily Zulz summarized in a recent ThinkAdvisor article[5], financial advisors' average allocations to alternatives rose from 5.7% in 2016 to 7.2% in 2017. This same Cerulli study states that 37% of advisors use liquid alternatives and 40% use some form of non-liquid alts.

But this still leaves about 60% who are not doing anything different from the traditional stock-bond-cash mix.

Moreover, those who do have an allocation to alternatives typically have less than 10% of their portfolio in such investments. For those who are investing in alternatives for capital preservation, 10% is just not enough to make an impact. How much protection can one reasonably expect from alternatives if 90%+ of the portfolio is invested in the same old fashion? For these strategies to make a noticeable impact, they would need 40%, 50%, or more to do the job.

Redefining How We Invest

If traditional asset allocation models failed to adequately protect investors during the Global Financial Crisis, why do so many of today's portfolios look indistinguishable from those from ten years ago?

Relying on traditional approaches despite their flaws and weaknesses is akin to fiduciary insanity. Doing the same thing over and over and expecting different results may be detrimental to investors' portfolios and thinking bonds will offer the levels of protection they have historically is unreasonable to assume.

There are more options than ever before for risk management. Utilizing options-based strategies or incorporating hedging strategies into portfolios may help address investor concerns with capital preservation and advisor concerns with meeting clients' growth needs.

Investor needs shouldn't be at odds with how their portfolios are constructed. With all the 2008 financial crisis reflections being published, this is a good opportunity to review portfolio models and financial plans and ask: What are you doing differently to meet client needs and concerns?

[4] U.S. Alternative Investments 2018: Accessing Evolving Alternative Platforms, Cerulli Associates
[5] Nearly 40% of US Advisors Are Using Alternative Investments: Cerulli, Emily Zulz, Sept 21, 2018

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Client Portfolio Manager, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research at Zephyr Associates for 11 years.

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