FLIRTING WITH MODELS AND COREY HOFFSTEIN

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09/07/2018

My most recent "Behind the Markets" podcast guest was Corey Hoffstein, chief investment officer of Newfound Research, fellow blogger, investor and podcast host. Hoffstein's podcast, "Flirting with Models," was offered in a bulk download for its first season, with all episodes released together. Hoffstein has been soliciting feedback for the second season, and there seems to be high interest in a look at portfolio construction. We were lucky to preview some of Hoffstein's beliefs on that topic ahead of a new round of guests.

Newfound's Core Beliefs

Many investors focus on alpha-seeking strategies, whereas Newfound focuses on managing risk and cutting drawdowns with risk-focused tactical asset allocation. Instead of trying to outperform the market by, say, 100 to 150 basis points, Newfound focuses on cutting losses on a tactical basis to help investors manage their own behavior of timing the market incorrectly.

Portfolios in Wonderland and the Weird Portfolio

There are a lot of factors that affect forward-looking returns, but Hoffstein's big-picture view involves low interest rates implying low forward-looking bond returns and higher-than-normal equity valuations implying below-average equity returns.

This creates a challenge for traditional portfolio blends, which Hoffstein wrote about in Meb Faber's latest book, *The Best Investment Writing: Volume 2*.

Using a set of capital market assumptions, Hoffstein discusses optimization -produced portfolios with very large weights to emerging markets and diversifiers such as gold and alternatives, as well as long-dated Treasuries. Hoffstein's takeaway from this "weird portfolio" optimization: to enhance returns in this environment one likely will be uncomfortable and especially uncomfortable versus the standard 60/40 mix.

Hoffstein made a great comment in the show describing the optimal portfolio as "first and foremost the one an investor can stick with."

The great challenge of this weird portfolio is thus whether an investor can stay with it over the long run.

Conservative Portfolios: Risky with 4% Withdrawal Rate Assumptions?

Hoffstein commented that, in past environments, different standard portfolio risk profiles (such as conservative, moderate or aggressive, with varying degrees of equity/bond allocations) largely did not matter and 20/80 bond/stock mixes or 80/20 stock/bond mixes largely would have led to retirement regimes that could support a 4% withdrawal rate based on the historical experience in higher interest rate environments.

Compared with today's environment, Hoffstein's work suggests the most traditionally conservative (fixed income-heavy) portfolios could be the riskiest to preserve a 4% withdrawal assumption.

Trend Following to Preserve Capital in Equities

We discussed sector rotation strategies and whether one uses momentum or value metrics to pick sectors, and Hoffstein has research that suggests both can work. But trend-following overlays, Newfound's primary focus (particularly for investors near retirement who have exposure to timing or sequence risk for their investments), are how Newfound says retirees can best manage market sequence risk—because retirees cannot earn back through jobs any losses in wealth due to market drawdowns.

While sector rotation is one primary strategy Newfound employs, Hoffstein's team is also deploying models that employ a multifactor equity model with trend-following overlays in terms of how much cash to put in a portfolio.

Why Do Investors Need to Focus on Capital Efficiency?

Hoffstein has been a public advocate for investing in a more capital efficient manner through the "prudent use of leverage."

One Hoffstein's central reasons for focusing on capital efficiency is the low absolute levels of expected returns we discussed, so getting maximum exposure and return for a given set of investment dollars becomes paramount.

Our discussion about 4% withdrawal rates creating more problems for fixed income-heavy portfolios is one big motivator for the use of capital-efficient strategies that add more fixed income exposure.

Focusing on capital efficiency and the prudent use of leverage, Hoffstein and I discussed the pros and cons of this type of strategy and when it would not work—most notably when stocks and bonds decline at the same time or when rising rate environments lead to a decline in equities.

Of course, the overall portfolio mix that incorporates more capital-efficient allocations will also dictate outcomes.

What Strategies Complement a 90/60 "Portable Beta" Strategy?

Hoffstein discussed how many institutional managers focus on portable alpha strategies in which they have a portfolio of "beta" exposures but then, without using up capital in their portfolios, they will add overlays that they think can add alpha—hence the term portable alpha. This 90/60 concept brings in portable beta by adding bond future beta on top of equities and allowing the additional capital in a portfolio to be used for other "diversifying overlays" or other thematic expressions.

Hoffstein and I discussed how managed futures strategies perhaps are one of the most logical complements to a 90/60 strategy in that they package exposure to short-term Treasuries that collateralize futures positions—and that is the type of exposure missing in a 90/60 strategy that incorporates bond futures on top of equity positions.

This was an interesting conversation about Newfound's investment approach and one of the advocates for new capital efficient ideas like the WisdomTree 90/60 U.S. Balanced Fund (NTSX).

Please listen to the conversation below.

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DEFINITIONS

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Drawdowns : Periods of sustained negative trends of return.

Basis point : 1/100th of 1 percent.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Short-term treasury bills : a debt obligation of the U.S. government with an original maturity of less than one year.