Evoke Insights: Slow and Steady Wins the Race

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In Aesop's famous fable of the Tortoise and the Hare, the slow and steady tortoise ultimately defeats the fast and foolish hare. The improbable victory demonstrates the virtue of consistency over speed. We believe a similar lesson is applicable to the world of investing where the focus is often on investment strategies with high recent returns.

The Math

To illustrate the compelling math behind the title of this month's *ARIS Insights*, we will compare a slow and steady portfolio to a high return/high risk allocation to measure which one earns more money over the long run. We will consider two specific portfolios: [1]

1. **Tortoise** – balanced portfolio of global equities, Treasuries, TIPS and commodities structured to be unbiased to shifting economic environments.[2]
2. **Hare** – 100% invested in global equities.[3]

The "race" began 25 years ago with each side starting with $100. As expected, the Hare got off to a fast start and built a commanding lead after the bull market of the late 1990s. The Hare's portfolio ballooned to $247 versus his counterpart's measly $180. The Tortoise caught up during the ensuing 3-year bear market by growing its pot to $194 while the Hare lost nearly half of his money. The Hare made up ground during the following bull market and lost it again amidst the financial crisis. One of the greatest bull markets in history during the final ten years of the race wasn't nearly enough as the Tortoise comfortably claimed victory with a final tally that placed his portfolio more than $270 ahead. The results are summarized in the table below:

		Bull Market	Bear Market	Bull Market	Bear Market	Bull Market
	Start	Sep '94 - Mar '00	Mar '00 -Mar '03	Mar '03 - Oct '07	Oct '07 - Feb '09	Feb '09 - Sep '19
Tortoise[1] Balanced Portfolio	-	+80%	+8%	+107%	-20%	+153%
	$100	$180	$194	$402	$322	$815
Hare[2] Equity Portfolio	-	+147%	-46%	+144%	-54%	+261%
	$100	$247	$133	$325	$150	$542

[1] These illustrative portfolios are hypothetical and are provided for discussion purposes only. They do not reflect the performance of any account actually managed by ARIS.

[2] The Tortoise (balanced portfolio) allocation represents: 25% MSCI World Index, 15% Barclays 20-30yr STRIPS, 35% ML 15+ Year US Inflation Linked Index, 15% Morningstar Global Upstream Natural Resources Index, 10% Gold.

[3] The Hare (equity portfolio) allocation represents: 100% MSCI World Index.

Interestingly, the Hare was running faster (performing better) than the Tortoise 83% of the time as bull markets dominated the calendar over the past 25 years. The intervening bear markets, while severe in magnitude were relatively brief, one lasting 36 months and the other merely 16. True to the fable, if you were observing the individual participants in the race it would appear the Hare was winning, because he was outperforming his foe 21 out of the 25 years. In reality, the big losses associated with equity drawdowns were too damaging and resulted in a losing bet over the full term!

The Reality

The example above demonstrates the mathematical benefit of minimizing losses over the long run. That said, the illustration likely understates slow and steady's margin of victory in practice. Thus far we have engaged in a theoretical exercise that assumes the investor holds on for the full ride, when in reality investor behavior often interferes. This is particularly true for more volatile portfolios that test one's conviction and patience during severe downturns, when the pressure to sell is generally greatest.

American Funds' Growth Fund of America offers a prime example of this behavioral phenomenon. At nearly $200 billion, it is the largest actively managed equity mutual fund in the industry. Its average return during the same 25-year period used in our example was 11% per year. This means that investors who held on during the steep equity declines would have earned an annualized 11% return. However, investors can be backward-looking beings, emotionally compelled to invest in strategies that have performed well and redeem from those that have not. The Growth Fund of America bears out this reality as the average investor only earned 7% over the full 25 years, a striking 4% less per year than the fund's average return.[4]

This simple data point captures a quarter century of bad investor behavior and offers a convincing reason to discount the Hare's performance more than the theoretical results presented. The 25-year span included two bear markets that cut the Hare's wealth in half and likely would have triggered sell-low behavior. The period also covered three bull markets doubling the Hare's wealth, which tends to provoke buying at the top (just before the next drop). The more balanced, steadier portfolio is less exposed to bad investor behavior simply because of the less severe ups and downs.

The moral of the story is to avoid equity-concentrated portfolios that are exposed to big losses because of the punishing mathematical and behavioral consequences. We believe that proper diversification (or the "slow and steady" approach) is a useful strategy for minimizing painful declines and delivering a better long-term return.

Implementation

Although most investors target more diversification than the Hare's 100% equity mix, the impacts of significant portfolio losses are still underestimated. Investors tend to fall short in their attempt to create a more slow and steady allocation. Take the traditional 60/40 "diversified" portfolio as an example. If we were to swap the

[4] Data source: American Funds using ARIS analysis. As of 9/30/19.

60/40 portfolio in place of the Hare in our race, the Tortoise's margin of victory would have <u>increased</u>, since the 60/40 mix is essentially a lower returning, more muted version of the 100% stock portfolio.

There is a substantial difference between the traditional 60/40 portfolio and the truly balanced portfolio. The balanced allocation is strategically diversified across asset classes – equities, Treasuries, TIPS and commodities – that are predisposed to perform differently in varying economic environments. The amount invested in each asset class is based on an allocation that makes the portfolio roughly unbiased to the ensuing environment. By contrast a 60/40 mix tends to be reliant on a favorable equity market (during rising growth and/or falling inflation periods) to drive performance.

We have been managing money according to these principles for decades and are now launching an exchange traded fund that invests similarly to the Tortoise portfolio described herein. Our goal is to develop a vehicle that can help simplify efficient implementation of a truly balanced strategy. There will be much more to come on this development.

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