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What, Your Portfolio is Not Positioned for Two-Sided Risk?

Hurry… you have a third risk to consider.

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If you oversee investments for your nonprofit and follow the news, not a day passes where you do not see conflicting accounts concerning the markets and our economy. Headlines declare large layoffs at iconic companies, yet U.S. unemployment rates recently dipped to a 53-year low. Inflation has moderated but families feel pinched, dampening consumer spending. Stocks have rallied on the hopes of a soft-landing, yet investors may be tempted to tamp down risk and own bonds yielding more than they have in years. *What is a sensible investor to do?*

We present all three risks, debunk several myths and share practical considerations for your portfolio.

Fiducient Advisors strives to help our endowment and foundation clients achieve attractive returns, while mitigating risk. Important tenets of our approach include constructing broad, thoughtfully diversified portfolios and avoiding market timing. Given extreme uncertainty in both the markets and the economy, the need for diversification and patience by your investment committee may be as important as ever.

Investors ponder the risk of recession and how that might impact their portfolios. The debate among experts repeatedly focuses on whether we will experience a hard landing (recession) or a soft-landing ("Goldilocks" environment where inflation is tamed, and recession avoided). This is the two-sided risk pundits argue and while these are legitimate concerns, we contend there is a third, less anticipated risk that should be on your radar. Below we present all three risks, debunk several myths and share practical considerations for your portfolio.

Risk #1: Recession is likely, I'm nervous. If you are in this camp, it is helpful to recall that recessions are an ordinary part of the economic cycle. Since 1950, the U.S has experienced a recession roughly every 6.5 years, with the average recession lasting about 10.5 months.[1]

So how might your portfolio be impacted by a recession? On average, markets peak seven months prior to an economic downturn and bottom out three months before economic growth resumes.[2] This means

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[1] *Source: Fiducient Advisors – The Bear Market Field Guide, June 30, 2022*

[2] *Source: Fiducient Advisors – The Bear Market Field Guide. June 30, 2022*

attempting to time the market can be a fool's errand. Moreover, history has shown time is on the side of patient investors as broad markets have recovered to pre-recession levels following each and every pullback. For a diversified investor, the benefit becomes apparent when considering recovery times.

In advising long-term investors, we underscore the value of thoughtful diversification as well as the challenges of market timing by pointing out the best days for equities have actually occurred during bear markets or recessions. In fact, the 10 best days of percentage gains for the S&P 500 Index all took place during recessions.[3]

Source: Fiducient Advisors, The Bear Market Field Guide. June 30, 2022.

Risk #2: Soft-landing, we are good to go! If indeed the Fed can tame inflation without forcing the economy into a recession, and we resume solid economic growth, this can translate to good news for a variety of asset classes. Even though diversification is often considered a risk mitigation tool, it can play a role in capturing upside potential. Investors placing all their investment eggs in one basket may miss the rally.

Lower interest rates would make the "safe play" (cash) more penal for investors. Equities, particularly small cap stocks, and high-yield bonds could fare well. And long duration opportunities (think growth stocks, venture capital, private equity, etc.) may experience tailwinds too.

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[3] *Source: Wells Fargo, Bloomberg and Wells Fargo Investment Institute. Daily data 9.16.1991 – 9.15.2021 for SP 500 Index*

Risk #3: No recession, anemic growth. This less-contemplated environment creates a sideways setting where we never quite experience a recession but, because the economy avoids its "medicine", we fail to achieve attractive growth levels for some time. Equity returns can be muted in this backdrop. However, fixed income may be relatively attractive and marketable alternatives (think hedge funds) could potentially shine.

Hedge funds - a challenged strategy for the better part of the "free-money, stocks soar" decade - could add value. But a middling economic growth scenario can present opportunities beyond hedge funds. Large companies with solid balance sheets but slow growth may be inclined to acquire faster growing small cap companies. And private equity shops with special situations expertise may shine.

Where does this leave us?

Whether we experience a recession or not, it is healthy to acknowledge that recessions are a regular part of our markets and economy. Because all three of the risks presented remain a possibility, investors would be wise to construct broad, thoughtfully diversified portfolios with the likelihood of at least some portion of their allocation performing well in any situation. This offers the prudent investor a fighting chance of achieving long-term goals, and that's about as much as we can strive for in this challenging environment.

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