WHY INVESTORS ARE RECALIBRATING

Their Portfolio Right Now

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1. Understand Your Needs – and Your Goals
2. Recalibrate to Include Equity
3. Consider Alternative Assets
4. Stay Flexible

Utilizing a total return approach enables the investor to take advantage of the multiple sources of value that arise from a diversified portfolio, thereby consistently increasing the value of the portfolio over time for a given level of risk.

In times of erratic uncertainty, consistency becomes a welcome respite. But consistency can also breed complacency at precisely the time investors need to adapt—particularly when it comes to reallocating a portfolio.

When the Federal Reserve recently signaled a renewed commitment to keeping rates near zero for the next few years in response to continued covid-19 concerns, smart investors likewise recalibrated their thinking to reflect that of the Fed. Responding and adjusting to a new interest rate paradigm of lower rates for the foreseeable future is of particular importance for investors who rely on their portfolio for income, said Kayla McComb, an investment analyst at Whittier Trust.

"If you are a retiree currently in the Vanguard Target Date 2020 Fund, for example, about 50% of your assets are invested in bonds. Given historically low bond yields and the recent Fed guidance, the necessity to rethink the role of fixed income in a portfolio becomes clear for a generation of investors accustomed to higher bond yields," said McComb. "Adjusting to the new world of persistently low rates isn't just limited to retirees. On the contrary, younger investors also need to recognize that today's historically low interest rates impact how their assets should be allocated and the returns they can reasonably expect to achieve."

Moreover, negative real rates across fixed income markets globally have required investors to recognize the value to be added by reallocating their portfolios away from such structurally challenged asset classes.

To address this conundrum, McComb suggests shifting to a "total return" approach, whereby the investor focuses on the combination of interest, capital gains, dividends and distributions — rather than just zeroing in on interest and dividends. Utilizing a total return approach enables the investor to take advantage of the multiple sources of value that arise from a diversified portfolio, thereby consistently increasing the value of the portfolio over time for a given level of risk. Here's how to apply this strategy to your portfolio's asset allocation.

Understand Your Needs—and Your Goals

When constructing portfolios, it is important to review key elements like time horizon, liquidity needs, and both the ability and the willingness to take risk. These factors can help re-frame your asset allocation to take advantage of the total return approach and avoid the problems posed by the current low interest rate environment. To do that, it's essential to consider any upcoming liquidity needs and your annual withdrawal rate from your portfolio. This will account for necessary liquidity reserves if you have obligations and avoid the need to sell assets at inopportune times that may cause a permanent loss of capital.

These needs are not necessarily age dependent. If you're nearing retirement, it may be a good idea to work with an advisor to assess your portfolio's asset allocation and make necessary changes sooner, rather than later. Similarly, younger investors at the accumulation phase of their investing lives also benefit from the total return approach.

Recalibrate to Include Equity

Reallocating your portfolio to incorporate a total return approach likely includes more equity exposure than the traditional investment strategy of matching the bond exposure to the investor's age.

"The current investment environment necessitates taking a deep dive into your asset allocation, not merely relying on the portfolio strategy you set five years ago," said McComb. "Although historically low interest rates demand overweighting equity versus fixed income in order to achieve your return objective, the risk perspective implication of this underweight to fixed income is to own stocks of high-quality companies."

"At Whittier Trust, we believe that quality will be rewarded over the long term; thus, our emphasis is on identifying high-quality companies with durable business models and sustainable competitive advantages, while avoiding those companies subject to binary outcomes or government actions," she added. "More importantly, we apply an ownership mentality, treating each investment as if we were buying the company, rather than trading the stock. This mentality results in identifying the best relative value opportunities within equities, which allows our clients to maintain the overweight to equities necessary for the steady growth of principle without assuming undue levels of risk."

Consider Alternative Assets

As you reexamine your portfolio, you may consider asset classes you haven't previously invested in, such as real estate, private debt or absolute return, as these investments can enhance the risk/reward profile of your portfolio. You may also consider broadening your current bond exposure to include multiple style classes within fixed income.

"For example, private debt may be another way to source portfolio income. Despite the spread tightening seen in public credit markets, middle market loans are still offering an attractive spread," said McComb.

It's important to note that some alternative assets, such as private market investments, may be illiquid for long periods of time. If you are investing within alternative assets, it is also important to complete proper manager due diligence to ensure that you are not taking on unnecessary risk beyond the asset class of the investment.

Stay Flexible

While interest rates may be close to zero for quite some time, investors need to be creative with their portfolios and not set it and forget it. Most importantly, now is the time to revisit a few key questions—what is my time horizon? Do I have any significant upcoming liquidity needs and what is my annual portfolio withdrawal rate? These will help frame the most important question of all—is my portfolio properly allocated to address those questions given the low interest rate environment?

"At Whittier Trust, we believe the optimal portfolio asset allocation for producing superior after-tax returns in the current investment environment consists of over-weighting high-quality stocks and productive real estate," said McComb. She notes that they regularly sit down with clients to address the questions above to ensure that each client's portfolio is designed for where they want to be tomorrow.

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