Asset Allocation Weekly

By Confluence Asset Allocation Committee

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We publish asset allocation thoughts on a weekly basis in a special section within our Daily Comment report, updating the piece every Friday.

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Earlier this year and late last year we recorded a series of podcast episodes that examined the issue of making decisions under conditions of uncertainty. Episode #5 discussed the issue in broad terms, offering a general framework for examining such decisions. In the end, the key to making these decisions comes down to process. Without a sound process, decision makers can swing wildly on new information or take unconsidered risks. In Episode #6, Mark Keller discussed this topic with a specific focus on how we make decisions in equity portfolio management. In Episode #9, Greg Ellston did the same for asset allocation.

Recently, the Asset Allocation Committee met to make portfolio adjustments. In the nearly two decades of being involved in such procedures, the current environment is perhaps the most unique for all members of the committee. Simply put, we are in an area of substantial uncertainty. The term "uncertainty" is not used lightly; we view the word in the sense analyzed by Frank Knight in his seminal work, *Risk, Uncertainty and Profit*. Risk is where known probabilities can be assigned; games of chance such as roulette fall into the category. Uncertainty occurs when probabilities cannot be accurately assigned. That is the world in which most portfolio management decisions are made.

In our recent reallocation, which is detailed in the Asset Allocation Quarterly, our general position is that the economy is almost certainly in recession, but financial markets have already discounted much of the damage of a downturn. Unlike most recessions, which occur due to policy error, geopolitical event, or inflation, this one is caused by a pandemic, which has almost no modern historical parallels. We have seen extreme and severe market moves already; the decline in equities is one of the fastest on record. New low yields have been established for long-duration Treasuries. Credit spreads have widened to levels not seen since the Great Financial Crisis. The key issue the committee had to determine was the likelihood that conditions would worsen beyond what the financial markets had already discounted. Our determination was that the odds that market conditions could get worse is possible but less likely than the prospect that much of the bad news is already factored into asset prices. That doesn't mean that some element of caution isn't appropriate but establishing the best positions to reduce portfolio risk is critical.

There were three themes that we applied to the asset allocation portfolio changes:

1. The sharp decline in long-duration Treasury yields reduces the utility of this asset class in reducing portfolio risk. Our earlier position in this asset class has served our asset allocation portfolios well, but the utility was deemed to be near exhaustion. There were two reasons for this determination. First, the expansion of the Federal Reserve's balance sheet will tend to raise inflation fears and thus slow further declines in long-dated Treasury yields. Second, the Fed's actions to narrow credit spreads will offer better opportunities in investment-grade credit. To that end, we shortened duration and increased corporate bond exposure.
2. The massive expansion of liquidity should favor precious metals. Although the dollar has been very strong due to the global scramble for dollars to service foreign-issued, dollar-denominated debt, the Fed has opened swap lines and other programs to improve global dollar liquidity. We expect these actions to temper the dollar eventually. The importance of gold as a portfolio hedge remains in place. An allocation to silver was introduced in the Growth and Aggressive Growth strategies.
3. We adjusted the portfolios regarding risk tolerance. Historically, steep declines in equities coupled with policy support have generally led to eventual recoveries in equities. There was an increase in equity exposure across all the strategies with the largest increases seen in the Growth and Aggressive Growth strategies. In these higher risk-tolerance portfolios, we added an allocation to emerging markets, which have fallen precipitously in this downturn.

Our CIO (and CEO) Mark Keller is fond of saying "we are not soothsayers, but oddsmakers." We are not predicting with certainty that the bottom in equities is in place or that credit won't deteriorate further. But, what we have seen from policymakers and our own analysis of how we believe the COVID-19 virus and the response will evolve over time leads us to the conclusion that the aforementioned three points are reasonable responses to current conditions.