

Olympic Dreams

I am confident the only thing that kept me out of Major League Baseball was my height. While it is true I never had the strongest arm, wasn't the fastest running bases and couldn't hit a curveball, had I been a few inches taller, professional scouts would have given me a chance.

Height limitations aside, professional sports never became a reality for me. Thankfully, my parents pushed me enough to excel in sports without going overboard. As the father of two growing tween-aged boys, I find myself fighting the urge to push them into the activities I enjoyed at their age. I want to nudge them towards greatness, but in the endeavours they choose and at a pace which gives them space to breathe.

Like most brothers, my two boys have different temperaments and interests. I often wonder what they might choose as vocations when they reach adulthood. My oldest sons' favourite activities are snowboarding, video games and art. I want my kids to follow their passions; perhaps one of these activities will be the basis for their future profession.

As a parent I have a choice to make about how involved I should be in their pursuits. Parental involvement is a delicate balance. If I believe my son could possibly become the worlds greatest snowboarder, I could take him out of school and get him a full-time private coach. If I think he has the potential to be the next great artist, I could send him overseas to study the European masterpieces. Of course, I don't need to go to those lengths, I could simply increase his exposure through his existing school or leverage local resources. Alternatively, I could do nothing at all to support his interests and let karma figure out where he will shine.

One way to think about how much effort (and money) I should spend helping further my son's interests, is my belief in his expected success. If I believe my son has a high probability of future success in something, I am more likely to sign him up for that extra lesson or hire that private tutor. If I feel his chances of success are low, maybe I just let fate do its thing.

What does future success entail? Does it mean the activity results in financial gain or a career at some point or does this simply imply my son has fun? And what about the costs associated with focusing on one activity to the exclusion of others? If I really took my 11-year-old son out of school and sent him to the Swiss Alps to study snowboarding, would that be a good idea? (Note: I have not discussed this option with his Mother).

When deciding how to help my son in his pursuit of success, I need to ask myself two questions.

- 1) If he succeeds, how large is the payoff?
- 2) If he fails, how much disruption has occurred?

The output for my son's activities might look like this:

	Snowboarding	Math	Art
Parental involvement	Hire a private coach so he can make the Olympics	Hire a tutor so he can make the math team	Send him overseas to study the European masters
Success/payoff	Lots of fun, No income potential	Some fun, High income potential	Some fun, Some income potential
Failure/disruption	Medium disruption	Low disruption	High disruption
Probability of Success	20%	80%	1%

If I hired him a private snowboarding coach, he would undoubtedly have a lot of fun, but the increased time spent at the hill would leave little time for math and art. Hiring a math tutor is not nearly as much fun, but math will have high applicability for the rest of his life and extra studying would still leave lots of time for other activities. Studying art overseas might be fun for a while, but it would entirely upend his life. In terms of potential future income; even Olympic gold medalists don't really make any money, being good at math can be lucrative and most artists require decades before their art is considered significant.

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As a father, I recognize the value of fun and so I might lean towards increased snowboarding training. However, experiencing Europe would be exhilarating. Even so, perhaps math is the most practical choice. With valid reasons to pursue each activity, what is the best way to weigh these different options? The objective answer is to use probability to guide decision making. Even though my son excels at snowboarding, making the Olympic team is unlikely (20% probability). He has a much better chance of making the math team (80%) while becoming a master artist is virtually impossible (1%).

From an investment perspective, building a portfolio is a lot like choosing between which activities to help my son pursue. In this analogy, the portfolio is 'my son' and investment options are different 'activities' to choose from. Instead of choosing between snowboarding, math and art, I am selecting from stocks, bonds, and commodities. There are good reasons to 'pursue' each of these investments, but I would be wise to ask the same questions I asked when choosing between my sons' interests.

- 1) If the investment succeeds (increases in value), how large is the payoff?
- 2) If the investment fails (loses value), how much disruption has occurred?

There is a subtle but important difference between this set of questions and the previous set. In the first set of questions, regarding children's activities, parents primarily focus on question 1 (success) because they are trying to choose the option that provides the greatest positive experience. Conversely, the same questions regarding investment options, investors tend to focus more on question 2 (failure) because there is the possibility of loss, and investors hate losing money more than they like gains. Unlike with making a wrong decision choosing an after-school activity, bad investment decisions often result in permanent loss.

I want to give my son the most rewarding life experiences, while minimizing the amount of potential disruption should things not work out as hoped. Portfolio construction has the same goal. In our simplified model where we are choosing between stocks, fixed income and commodities we could simply select the highest returning asset class and disregard the other two. Many investors do this. However, the eventual highest performing investment will largely depend on whether your assumptions about the future prove true. If you believe;

- economic growth is permanent; hold stocks
- the world is going to spiral out of control; hold fixed income
- hyper-inflation is around the corner; hold commodities

The problem is, all three of these things cannot be true at the same time. I believe there is a kernel of truth in each of these statements; the market is powerful, the world faces serious challenges, and inflation is real. However, the future is not static. Because we are concerned about downside risk should our assumptions prove imperfect, we should choose to hold at least some of each asset class and avoid making narrow bets. Of course, that begs the question, how much of each asset should we hold?

Different activities are more appropriate for my son depending on his age. Similarly, different investments will be more or less attractive depending on the age of the current economic cycle. Waiting until age 20 before hiring a snowboarding coach with hopes of making the Olympic team is not a good plan, nor is loading up on speculative stock investments after an extended market run. To tilt the odds of success in our favour, we will use this concept of age to adjust our probability assumptions.

Over time, assets tend to revert to their long-term average rate of return. Our probability assumptions need to reflect how recent returns compare to their longer-term average. For example, if the 15-year average rate of return of stocks is 9%, and the recent 5-year return has been 14%, history suggests stocks will return below average in the following period. Whenever investment performance has been better than average, it must undergo a period of underperformance in order to get back to its long-term average. Under this scenario, we should lower our assumed probability of success for stocks.

In the following chart we can see the long term returns and recent performance of each of the asset classes under consideration. Stocks have had a terrific run, having performed 56% higher than its long-term average. Fixed income on the other hand has not lived up to its average performance and has returned 44% lower than its long-term return. Commodities have had terrible performance relative to its long-term average and are off almost 90% from its usual returns.

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	Stocks	Fixed Income	Commodities
Long term return	9%	4.5%	8%
Recent (5 year) return	14%	2.5%	1%
Premium/(Discount) to long term average	56%	-44%	-88%

Given this information, we should weigh our portfolio to take advantage of the power of reversion to the mean. We don't need to start from scratch though. If we are building a "balanced" portfolio, meaning we want to generate a "stable" return, we simply need to adjust the weights to what academia has found over decades to be among the steadiest approaches – 60% stocks and 40% fixed income. Given stocks are most overvalued relative to their historical returns we should hold less than 60%, the proceeds of which we should allocate to the two assets which currently trade at a discount to their long-term averages. This is what we are doing now in our portfolios at Stewart Financial.

The first six months of 2021 have resulted in strong growth. Central banks have kept interest rates low, and the economy continues to rebuild from the covid-induced shutdowns. The back half of the year will build on these developments, but mean reversion requires us to make portfolio changes commensurate with what the future likely brings. As Babe Ruth once quipped, "yesterday's runs don't win today's games".

Your *should have spent more time learning to hit that curveball* portfolio manager,



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