Coaching for permanence

The average tenure of a professional baseball coach is 4 years. Professional American football coaches last 3.5 years. Professional basketball coaches only last 2.5 years and the worst job security belongs to professional hockey coaches, who on average last 2.3 seasons. Professional coaches have a limited amount of time to get their millionaire players to forget the bad habits taught by the last coaching group, and instill their new program.

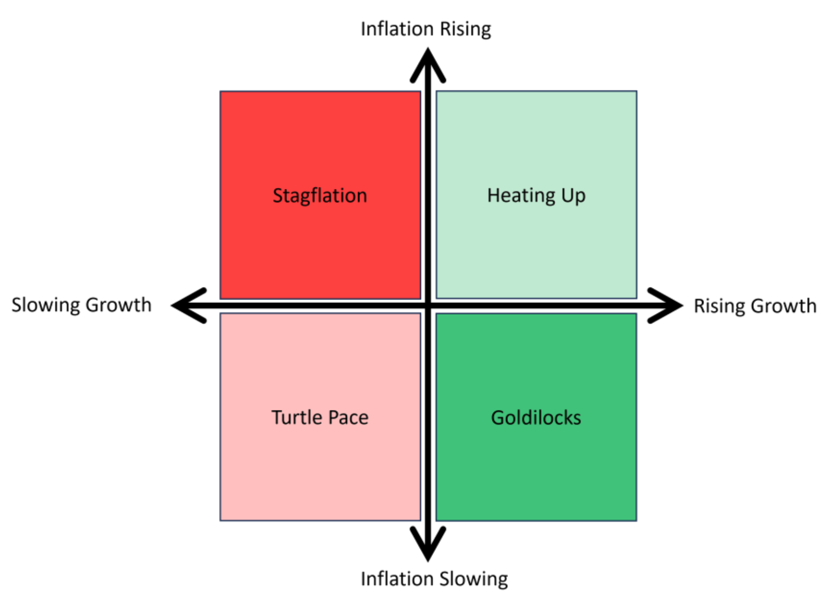
Every coach has a bias in the way they want their players to engage on the field of play. Some coaches are aggressive, demanding players take large risks hoping to generate many scoring opportunities. Other coaches are more cautious, and design plays to minimize their opponents' chances. The most successful coaches recognize the correct strategy is situationally determined; aggression and caution are both appropriate strategies during a game, depending on the circumstances.

If a team can establish an early lead in a game, perhaps being defensive makes sense, whereas being defensive when your team is facing a large deficit is counterproductive. Good coaches understand that the optimal strategy changes with the flow of the game, and flexibility is critical. The coaches that can't adjust have the shortest professional lifespan.

Designing a resilient portfolio of investments is no different; strategy should be modified as circumstances change. Just as a sports team needs both offensive and defensive specialists, so should an investment portfolio. Determining the appropriate mix is more art than science, but the economic backdrop provides meaningful clues. Most economic data should be viewed through a probabilistic lens; the future state of the economy cannot be forecasted with pinpoint accuracy, but historical context aids in thinking about what is most likely. Future probabilities should inform positioning and allow a portfolio to skew more or less defensively over time.

Two valuable economic factors that should impact portfolio positioning are *growth* (how fast the economy is expanding) and *inflation* (the general rise in prices). These two concepts are linked because over time strong economic *growth* leads to *inflation*, while weak economic growth reduces it. All investors want the economy to grow, but not so quickly that prices skyrocket. Inflation that is too low is also undesirable, because that is indicative of minimal growth or a shrinking economy. Stable growth with associated slow, steady inflation is the optimal economic regime.

The economy is never stationary. Like waves moving across the ocean, it is in constant motion. As the economy changes, often because of changes in interest rates, the relationship between economic growth and inflation adjusts. The graph to the right illustrates this relationship and the resulting economic consequences.



The ideal economic scenario is represented in the southeast quadrant; rising growth and inflation slowing. Here, the economy is expanding, but at a pace that keeps inflation under control. Because this environment is characterized by growth being 'not too hot and not too cold' it's called the 'Goldilocks' scenario. This was the state of the economy during most of the 1980's and 1990's, which is why the stock market performed so well during that period.

The northwest quadrant, slowing growth and inflation rising, is the opposite of the Goldilocks scenario and is economist's least preferred state. This period is represented by poor growth, yet counterintuitively, increasing prices. The term for this scenario, 'Stagflation', is the fusion of 'stagnation' and 'inflation'. This situation typically occurs because of a spike in commodity prices or sudden shock to supply chains in the face of strong consumer demand. The 1970's experienced stagflation when oil prices spiked, and unemployment rose precipitously. An economy mired in stagflation is difficult to repair and typically results in high interest rates.

The northeast quadrant, both rising inflation and growth, is usually the start of a longer positive trend and typically coincides with a strong stock market. Typically, this environment arrives after a period of economic malaise as the economy starts to rebound, which is why it's termed 'Heating Up'. It is during this period that some of the largest investment gains are made, but also one where many miss out. Because investors are scarred from the preceding volatile period, many are still on the sidelines; a reminder that investors should never be totally in, or totally out of an asset class, but make meaningful tilts along an investment's lifespan.

The southwest quadrant, both slowing growth and inflation, results in the economy moving at a "Turtle Pace'. There will be sectors which perform well, but overall, this period is characterized by sideway market returns. Investors like low inflation but aren't enamored by weak growth.

These periods bleed into each other rather than start or end abruptly, and investors should never make a one-direction bet, diversification is still paramount. However, we can use history as a guide to help shape our portfolios to avoid aggressive positioning when most precarious and tilt toward defensive positioning when advantageous.

The most likely scenario for the period ahead is *Turtle Pace*. *Stagflation* might have been a concern if unemployment rates were significantly higher, but employment is currently among the brightest economic data points. It is unlikely we are embarking on either *Heating Up* or *Goldilocks* in the near term as economic growth is not accelerating given the mountains of debt in the system among governments, corporations, and individuals, as well as aging demographics across the developed world.

The chart below illustrates appropriate asset allocation positioning under each economic regime. These are guidelines rather than exact prescriptions, but they illustrate the positioning bias. Intuitively, when economic fundamentals are improving, a more offensive stance is appropriate, but if fundamentals are weak or deteriorating, a more defensive mix is best. At all times each scenario has exposure to both offensive and defensive investments, though the weights vary from high to low (Lots – Some – Limited). As displayed, a *Turtle Pace* asset mix would include 45% offensive strategies and 55% defensive strategies, making the overall bias cautious.

	Heating up	**Goldilocks**	**Turtle Pace**	**Stagflation**
Offensive investments	Lots	Some	Some	Limited
Defensive investments	Limited	Some	Some	Lots
Offensive/Defensive mix	*70/30*	*55/45*	*45/55*	*30/70*

Currently, our client portfolios are leaning defensively until interest rates peak and relax, and earnings re-accelerate. This may take longer than the market is hoping. This means significant weightings in fixed income, dividend paying stocks and higher yielding securities, and limited exposure to investments or companies requiring a rapidly expanding economy and low funding costs. Many defensive investments currently offer mid-single digit yields, with limited downside, which makes them ideal investments to hold while we wait for better economic conditions. There will be a time to increase offensive assets, but economic realities suggest now is prudent to be defensive.

Your *happy my lacrosse coaching position is volunteer* portfolio manager,

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