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MARKET MATTERS: Have enough ballast in your portfolio?

By Joseph Matthews

June 3, 2018

It’s that time of year again. Boaters are preparing their boats in anticipation of a summer season of sailing, fishing, skiing or cruising. Adding ballast to a boat’s hull is one step a boater may take during this pre-game warm-up. This annual tradition is done to remedy potential issues and make the boat operate as efficiently and safely as possible.

Ballast is a heavy substance placed in such a way as to improve stability and control. Although this word is typically used as a maritime reference, it also can be used in reference to something that provides steadiness or strength in a particular situation.

In the context of portfolio construction, it’s about those types of investments that can perform relatively well when others in the portfolio are underperforming.

Of course, we can’t put sandbags in the hull of our portfolio like we could in a boat. What we can do, though, is add investments that improve diversification with the goal of reducing risk relative to our desired return. This may seem boring, especially after a nine-year-old bull-market that’s produced outsized returns — about 300 percent for the Standard and Poor’s index of 500 equities since the lows made during the Great Recession.

That being said, it could be high time to start thinking as much about protection as return. By giving some thought to investments that could improve the overall risk-return profile of your portfolio, you’ll help position your portfolio to weather potential rough seas that inevitably rock the financial worlds.

Speaking of those potential storms — there have been signs of them recently.

Just this past week, the CBOE Volatility Index (VIX) — a measure of the expected volatility in the SP500- jumped 38 percent during trading on Tuesday. This index has closed with a gain of 30 percent or more four times this year, already surpassing the 2017 total of three times. Additionally, the actual volatility of the SP500 has increased significantly. That index has seen a move up or down of larger than one percent 33 times this year — well in excess of the eight times it happened in 2017 and on track toward its long-term average of 70 times!

Taking advantage of investments that can reduce volatility in a portfolio serves a few purposes. For investors in the “distribution” or spending stage of life, it minimizes the need to take withdrawals at inopportune times when a portfolio’s value is low. For investors in the accumulation phase, it makes for an easier ride and helps keeps them away from the danger zone of making a bad decision when markets aren’t performing well.

So what to do? Investing some of the money you’ll be using to satisfy short and medium term obligations in short-term U.S. government bonds — with rates at the highest levels seen since 2008 — can help increase your returns. Adding investments that historically have done well when interest rates go could also help. Examples include: U.S. government bonds with coupons that adjust with inflation (TIPS), common stock in companies that sell products that typically experience price increases (commodities such as steel, aluminum and gold), and investments in private partnerships that give investors access to private loans, private companies and private real estate. Although the latter investments can be accompanied by illiquidity, the structure of the investment often works to the benefit of investor by allowing the money manager to make longer-term investment decisions.

Preparing for a different environment is what wealth management is all about. Diversify. Manage risk. Prepare for changing conditions whenever they occur.

And, values matter, too. A good financial adviser will provide personalized advice combined with technological innovation to help structure portfolios consistent with one’s social, environmental or ethical values allowing investors a way to advocate through their investments without comprising their financial goals.

What investors wouldn’t want a smoother ride on their journey to meeting their financial goals?

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