Is Borrowing Money To Increase Returns A Good Idea?

Saturday's With Jim

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Dear Friends,

Cory Hoffstein, in his *Flirting with Models* blog post of December 4, 2017, "Portable Beta: Making the Most of the Returns You're Already Getting,"[i] shows how to dramatically increase returns in a 60% stock, 40% bond portfolio by applying enough leverage (borrowed money) to the bond portion so that the bond portfolio's volatility equals the stock volatility. Over a ten year study period, his juiced portfolio (think of a souped up Model T) outperformed the stock only portion of the portfolio by 12% to 9% annually while keeping overall volatility below that of the stock only level. Should we find his risk parity example enticing enough to use it in our portfolio designs?

Risk Parity

Risk parity relies on the volatility of the bond portion to be stable so it can contribute to increasing overall portfolio gain through price gains and income that bonds pay. Risk parity is a super strategy as long as bond prices are stable or rising - interest rates are not going up. But imagine a scenario when bonds are actually losing money because of interest rate increases. In those rising rate periods, we would be borrowing money just to magnify our bond losses.

Tactical vs. Long-Term Investing

Hoffstein has the kernel of a great tactical investment strategy, one that is employed over a relatively short time to capitalize on a certain set of circumstances. If the relationship between stocks and bonds goes against him, like bond rates rising and bond prices falling, his 60/40 portfolio may experience a volatility spike while suffering lower returns than he would have gotten had he left 60/40 intact. Tactical investing requires a degree of sophistication and luck which we cannot promise to have- we don't profess to know when the behavior of two variables (stocks and bonds) might diverge from our protected path, wrecking our tactical move and causing interest and trade expense to boot. Yet we are not content to run portfolios which do not have a decent chance of providing greater performance or lower volatility than a standard portfolio might.

How We Prefer to Add Value

Our investment program, Racing Turtle, is our answer to a 100% stock portfolio, but with lower risk than the market and a solid chance of slight outperformance over a full market cycle.

Our other programs use a dynamic allocation between stocks, bonds and cash keyed on positioning within the economic cycle. Dynamic allocation seeks to keep account volatility fairly constant even as market risk goes from low to medium to high and back to low again. Coming out of a bear market, stocks are free of the speculative excess they had before the long descent began, are relatively cheap and pose little risk of loss as those who wanted to sell have already sold. As the economy improves, stocks rise until some peak moment when a catalyst, usually a Federal Reserve tightening move which constricts credit and makes stocks less attractive to own than at prior points in the cycle. Our dynamic allocation strategy may seem complex, but it only requires about four major moves over a five to ten year period. Right now, after almost nine years of generally uninterrupted economic and stock market growth, we are one notch below our maximum allocation to stocks. The way ahead still looks clear, but pressures are building in the form of historically high stock valuations and monetary tightening by the Federal Reserve.

All investors must have a strategy or they are toast before the grill of chance. We believe that our two strategies offer the best risk/reward tradeoffs that an investor can reasonably get without having some sort of insider edge over others.

Thank you for investing with us.

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[i] https://blog.thinknewfound.com/2017/12/portable-beta-making-returns-youre-already-getting/

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