The Behavioral Portfolio by Phillip Toews

Summary – The Behavioral Portfolio was written for financial advisors, but would also be useful for engaged individual investors. It covers a lot of ground. The biggest takeaway is that investors should be prepared for much worse than they probably are. We tend to base what could happen on what has happened in the fairly recent past, but this is not representative of everything that could happen. Even going back multiple generations only shows what did happen, not what could have happened. Toews posits that investors discount the Great Depression as something that could never happen again, but really much worse could happen. Investors should be prepared mentally for a worst-case outcome and should also have their portfolio prepared to sustain them even in a very bad market.

The book starts out with a fictional narrative that is very representative of what likely happened often. A high-income client with little investment knowledge finds a very knowledgeable financial advisor who helps her construct a portfolio to get her to retirement. When the market crashed during the Great Financial Crises, he continued to urge her to be patient, but she finally reached her breaking point. He then repositioned her to a very conservative portfolio – right before the market made a strong recovery. The gist of the story is that it is very difficult for advisors to keep a client in a good long-term portfolio, as strong market moves up and down cause even smart, rational clients to react to past trend rather than to stick to a long-term plan. Advisors not only have their own biases, but also need to respond to client's demands in order to keep the business. Toews relates a 2009 study that showed that "advisors tended to lower returns, raise portfolio risk, increase the probability of losses, and increase trading frequency and portfolio turnover." Advisors, on average, are not doing a great job of keeping clients invested in sound long-term strategies after these strategies underperform for a few years.

Stocks are riskier than many believe. Toews notes that each of the last twelve decades have had at least one bear market (20% loss), with the average of two per decade, and the average loss per bear market of 36%. Even the Great Depression was not an extreme outlier – other countries have had similar or even worse crashes. Readers may be tempted to shift some of their stock allocation to bonds, but Toews goes on to show how risky bonds are. Defaults are more common than one might think, and inflation is the secret killer for a bond portfolio. Bonds may be even riskier than stocks for a retiree because of inflation. Rebalancing typically helps mitigate risk and even improves returns, but it can turn negative in a prolonged downturn for one asset class, such as stocks experienced in the Great Depression. Stocks started falling in 1929 and didn't bottom out

until 1942 after losing 84%. Two years later, bonds entered a bear market that would last thirty-six years. Toews chillingly notes that while this is the worst that has happened so far, this is not the limit on how bad things could be. "Markets are unbounded."

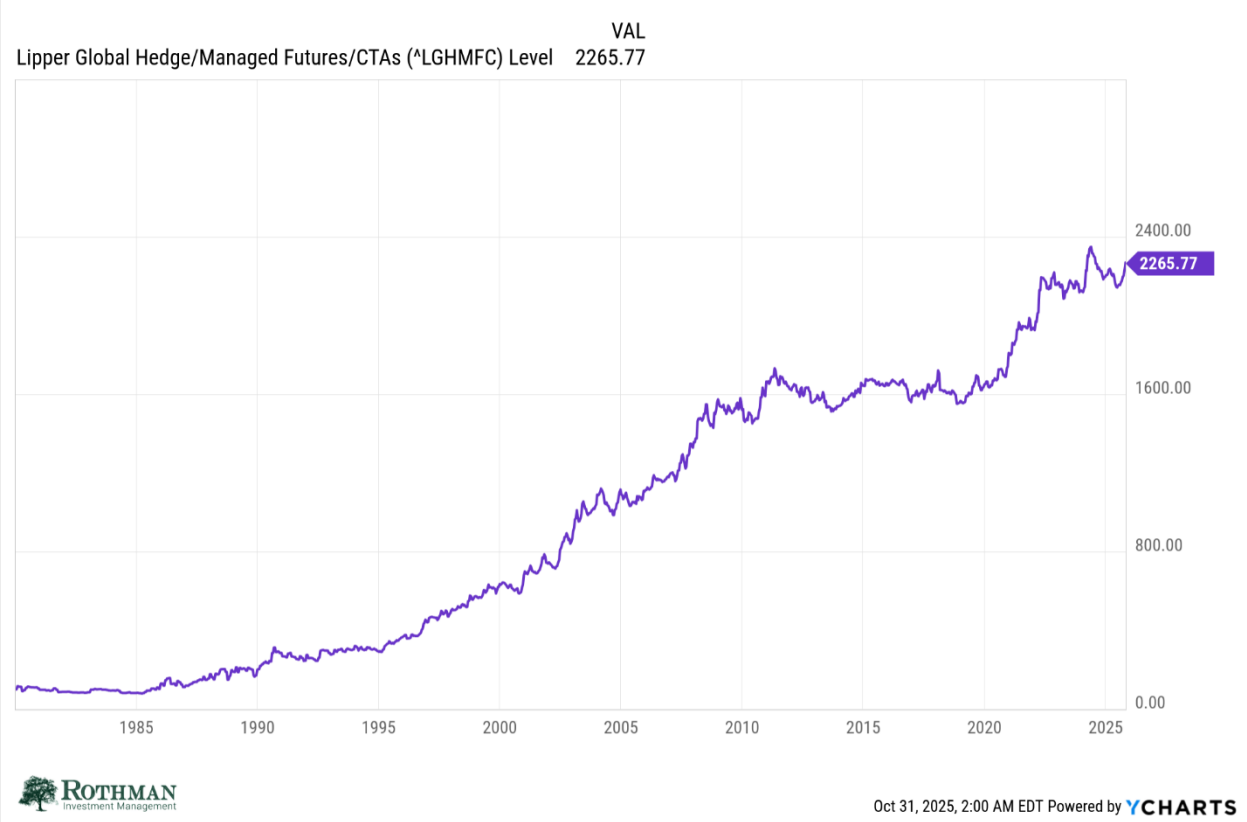
The solution – Toews lists the criteria to consider when building "behavioral portfolios": address risk of extreme negatives, provide long-term growth in excess of inflation, participate in rising markets, preserve gains, seek consistency of returns and include "primarily reliable, understandable sources of growth and/or income." He sees the way to do this as starting with a traditional 60/40 portfolio (60% stocks, 40% bonds) and making the bond allocation "adaptive fixed income", and making half of the equity allocation hedged equity. Adaptive fixed income means funds that give managers the ability to move around among various sub-asset classes within fixed income to seek the best risk-adjusted return for any current environment. Hedged equity means stock funds that buy options as downside protection to lessen losses in a very bad market. These have lower returns over time than traditional equity funds, but a narrower dispersion of returns. The book makes the case that investors should be content with a lower return in exchange for less downside risk.

One interesting observation is that dollar-cost averaging helps boost returns during an investor's accumulation phase (when adding to savings) and the more volatile the portfolio, the more it helps. The opposite is true once a retiree is drawing from the portfolio. While traditional investment advice is to avoid volatility, all else equal, young investors should actually pursue more volatile portfolios.

The book ends with a section on how to communicate to clients about what to expect and how to emotionally prepare.

Critique: there is much to like about this book, which identifies a major weakness in both retirement planning and financial advisors' relationship with clients. The book does a great job of looking at historical precedents that investors should consider. It highlights how much more extreme losses can be than most people expect. It stresses the importance of being prepared for very bad outcomes so that one isn't taken by surprise. I have just a few concerns. First, while preparing for very bad outcomes sounds reasonable, there was no consideration of the probability of the bad outcomes – only the severity. Buying homeowner's insurance is generally prudent, but buying flood insurance if my house is situated somewhere that would only flood once every five hundreds years may not be the best use of funds if the policy is priced too high. This is a minor quibble, as I agree with the author that most people underestimate the likelihood of another Great Depression-like loss in the US stock market. My bigger issue is with the solution of putting half of the portfolio in hedged equities, which in general have a dubious track record. It is

questionable how helpful they would be in a very bad, prolonged negative market, as hedges would run out and need to be replaced with much more expensive options contracts (pricing rises during times of uncertainty) at lower strike prices. And with rebalancing, a prolonged bear market would still subject the investor to selling the more stable hedged equity to buy the falling unhedged equity. (Remember, rebalancing generally helps, as markets are mean-reverting, but in prolonged trends it can hurt.) Finally, the book ignores or dismisses other options such as trend-following, factor-based investing to boost returns and get exposure to other risk premia, and adding non-correlated or lowly correlated assets. The book mentions commodity investing, but sees it as unhelpful, as the average commodity return is less than inflation. While this is true, holding a basket of commodities and rebalancing can produce a positive inflation-adjusted return due to the rebalancing effect – commodities tend to be trend-following in the short-term and mean-reverting in the intermediate and long-term. Adding a trend-following filter to commodities historically would have reduced drawdowns and improved returns. The book also states that managed futures have a zero return before fees and a negative return after. The actual managed futures index tells a different story – returns have been positive even after fees, and correlation to stocks and bonds is virtually zero.



Fees for managed futures funds or other uncorrelated assets are definitely an issue, but the same can be said for hedged equity funds. Working with a good financial advisor who is sensitive to fees can help an investor navigate this space.

Conclusion:

This book is a great read, and every financial advisor should read it, as should more ambitious individual investors. It does present an innovative solution, which is worth consideration, but unfortunately, it ignores some other potential solutions that should be compared side by side.