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EP 169 | Looking Past the Pitfalls: Focusing on Managing Risk in the Balanced Portfolio

[00:00] Andrew Johnson: Hello everyone. I'm very excited to share today's podcast where I talk with Steven Visscher, lead manager on our balanced portfolios here at Moore. We cover a lot of ground in relatively short amount of time, touching on the macro and market themes that he's navigating. Why we haven't been able to keep up with the strong overall market performance lately. How he and the asset mix committee approach building the portfolio and the current positioning of the strategy and the reasoning behind it. With that, here's my conversation with Steven Visscher.

[00:36] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:00:46] Andrew Johnson: Hey Steven, how's it going?[00:00:48] Steven Visscher: Really good, Andrew. Thanks for having me on the podcast today, and I'm looking forward to our discussion.

First off, I had to do a little bit of a double take on this because I just assumed we've had you on before, but this is actually your first time on the podcast. So welcome, and thanks for making the time.

[00:01:03] Steven Visscher: Excellent. Thank you, again, so much for having me.

[00:01:06] Andrew Johnson: By way of introduction for our listeners, you play a few different roles here at Mawer. In addition to being the person who has won the office hockey pool probably the most over the 20 years or so that you've been at the firm, you're also an investment counselor working with many of our individual and family clients.

Another important role is the lead manager on the balanced strategies that so many of our clients come to us for, both from individuals and families that you work with, as well as institutions like endowments, foundations, and pension plans that I work with. That's where I want to spend most of the time today. Just getting your insight and perspective on the balanced portfolio and the role that it plays for our clients. Let's start with the market environment over the last couple of years and how things like rising interest rates, inflation, or any of the other variables out there have impacted the performance of the balanced portfolio.

[00:01:53] Steven Visscher: Well, Andrew, you mentioned interest rates and inflation. Those two themes are very much connected. When I reflect back on the last three or four years, I believe they've had the most influence on the direction of capital markets and, by extension, the performance of our balanced strategies. If we go back to the onset of COVID, for example, what we saw was a real unprecedented response from authorities to alleviate the shock of the COVID pandemic, and that included bringing interest rates down to ultra-low levels.

What we saw in response to that was a strong rally in the markets. The initial losses from COVID were very quickly recovered, and we ended 2020 in a positive way. Even in a balanced portfolio, we had strong, absolute results. That momentum continued in 2021, again supported by this ultra-low discount rate environment. Then the narrative on interest rates quickly changed. As we got into 2022, we saw this surge of inflation that was well beyond the comfort level and targeted ranges of central banks. So they shifted focus and embarked on a very

fast and aggressive interest rate hiking cycle, which left very few places to hide.

What we experienced in a balanced portfolio was significant losses, both on the equity and on the fixed income side. That led to a disappointing result in 2022 and really the first meaningful loss in a balanced strategy since 2008. The narrative shifted once more once we became more and more confident that inflation had peaked and was starting to subside and trend back toward central bank targets. Investors grew enthusiastic about the notion of interest rates trending lower once again. That's what we've seen through 2023, and thus far, 2024 has been a real strong recovery in absolute terms. So it's been a roller coaster of a few years, but I would say that inflation and interest rates have been at the forefront of those events.

[00:03:52] Andrew Johnson: Yeah, it's been a bumpy ride for balanced investors these past few years, and frankly, it's been hard to ignore the headlines and the financial press basically writing obituaries for balanced portfolios over the last couple of years. From your perspective, do you think the 60/40 balanced portfolio structure still has merit as an investment approach?

[00:04:09] Steven Visscher: You're giving me flashbacks to 2022: The death of the 60/40 portfolio. How do you think that felt from a balanced perspective, reading that on a regular basis? In many ways, it's understandable. I think we've had an entire generation of investors that grew accustomed to positive fixed income returns whenever equities experienced significant declines.

We saw that at the onset of COVID. We saw it in the financial crisis of 08/09, and even going further back, the bursting of the tech bubble and the ensuing recession in the early 2000s. In each of those instances, the response from authorities was to aggressively reduce interest rates and that provided a positive backdrop for fixed income to help alleviate and offset the more significant losses on the equity side.

But 2022 was very different. The catalyst, as I said, was a surge of inflation, and the appropriate response from central banks was not to cut rates but to raise them. So again, what you had was not just serious equity losses, but alongside that were significant losses on the fixed income side. So that led many to question: "What's the role of bonds in the portfolio? If they didn't bail me out like they were supposed to, then why are they there?" At the time, our view was obviously not to panic. We took a calm and responsive approach to that.

In many ways, we viewed the silver lining of 2022 as that in a higher yield environment, the future outlook for fixed income actually looks more promising than it has for quite some time. We weren't exiting bonds. We were taking opportunities through that environment to incrementally add to bonds. Patience has been rewarded. What we've seen is that 60/40 portfolios have bounced back through 2023 and thus far in 2024 on the backs of positive fixed income returns to help support the overall balanced strategy.

[00:06:05] Andrew Johnson: More specific to the balanced portfolio here at Mawer, can you give us a brief overview of how the portfolio has been performing compared to its benchmarks over the last few years?

[00:06:14] Steven Visscher: Really good question, Andrew, and I'm sure that's on the minds of many listeners. As I've described, the 2022 rising rate environment had a more profound negative impact on growth companies. These are businesses that I would describe as having more of their value derived from cash flows that are occurring later in the future. Those are typical of the companies we see across our equity platform. We believe that, in the long run, those are the types of businesses that can exhibit long-term positive returns for investors.

But in 2022, they proved to be a little bit more susceptible and sensitive to rising interest rates and led our portfolios to have larger declines in the underlying benchmarks. As markets recovered in 2023 and 2024, what we've observed is that that recovery has been led by a narrow subset of businesses. Think of companies like NVIDIA and others that are part of that euphoria around artificial intelligence (AI). They've had extraordinary

returns, which has lifted the benchmarks to new heights but has posed a challenge for investors like us who weren't heavily exposed to those industries to begin with. So even though the absolute returns in the recovery of 2023 and 2024 have been great, we've continued to trail on a relative basis.

Now, we know that's a disappointing result for many of our listeners, but what I want to leave you with is that as uncomfortable as this is, it's a normal aspect of investing. There have been times over Mawer's 50-year history when we have underperformed, and we have had periods like we're going through right now. What has been the remedy for those situations has been a few things. One is just to be patient. Time tends to resolve these things. We're continuing to adhere to our philosophy, follow our process, adopt a long-term perspective, and it's our view that we'll eventually be rewarded, and clients will continue to experience excellent results as they have in past periods of underperformance. So I see no reason why this instance would be any different than the past.

[00:08:08] Andrew Johnson: That's a great segue because I wanted to step back a bit and talk about the philosophy and the process that governs how the portfolio comes together. Can you walk us through the who, what, when, where, and why of building the balanced portfolio here at Mawer?

[00:08:20] Steven Visscher: Sure. Like all of the other Mawer portfolios, the decision model is leader decides with input. So let's start with the input. We have a longstanding Asset Mix Committee at the firm. This is a forum that meets on a regular basis, and it's an opportunity for my co-manager, Greg Peterson, and myself to really gather the wisdom and pick the brains of many of our research colleagues.

So that meeting is regularly attended by Christian Deckart, our CIO. He provides his perspective on the broader equity platform. Crista Coughlin from our fixed income team shares her views on interest rates, inflation, and her macroeconomic outlook. And Jim Hall, our president, longtime money manager, and former leader of the research team. He shares his own unique views of a long history of the macroeconomic environment and his own perspective on risk. In addition to that internal gathering of information, both Greg and I subscribe to a couple of different external research publications that help round out our views on capital markets. After gathering all of those inputs, we then look to best position the balanced portfolio for long-term success.

One thing I want to also share – and I think it's important to note – is the way that we think in a probabilistic way. The objective of gathering all of this information isn't to forecast who's going to win the next election, the precise path of interest rates, or exactly where we are in the business cycle. We don't think we have an edge in doing that type of prediction or forecasting, but instead, we want to position the portfolio to be resilient across a broad array of scenarios. We're not zeroing in on one particular set of circumstances in one scenario and then aggressively positioning the portfolio to benefit from that. But we always want to be intellectually open to the fact that there's a whole host of scenarios that could unfold, and we want to have a certain amount of resilience regardless of what scenario does, in fact, unfold. And that's just to help us recognize that we're operating in a very uncertain and dynamic environment.

[00:10:18] Andrew Johnson: To come back to some of your earlier points, I presume that in periods of both extreme volatility but also underperformance, there can be pressure to make drastic changes like you were alluding to. How do you resist that pressure and maintain the disciplined approach that obviously has served us so well over the long term?

[00:10:36] Steven Visscher: Good question, Andrew. As balanced investors, Greg and I aren't motivated to try to make short-term, tactical changes. We're not driven to outperform over the next quarter. We're not looking to make any heroic, aggressive changes in the portfolio for a quick victory. We continue to adhere to a process of positioning the portfolio for long-term success and that also aligns with Mawer's firm value of keeping a long-term perspective. As you said, it's tempting, and there is pressure to make a big change and try to recover lost ground, but that just doesn't enter our conversation, and we're continuing to stick with what's worked for 50 years.

[00:11:12] Andrew Johnson: This has been really useful in understanding things, and I'm sure it is for our listeners, too. Let's bring it all together, and talk about how the portfolio is currently positioned and how we got here.

[00:11:22] Steven Visscher: Well, in a “Be Boring” fashion, we're actually not far from neutral. Our equity weight is just over 60%. Within that equity component, we continue to be slightly overweight to U.S. and international markets. We're neutral on Canadian large cap, and we're slightly underweight on our small-cap strategies. But again, that total equity weight is not far from 60% neutral. On the fixed income side, we have been holding a larger amount of cash than is normal. But as I said, we've been gradually deploying cash into our Canadian bond strategy over the last year to a year and a half. So that also is not far from neutral.

Cash is just around 5% and fixed income is around 34%. I think that neutral stance just simply reflects how uncertain the current environment is. There's certainly been a lot of talk about the coming recession. I mean, that's been talked about for years now and that continues to be our base case scenario is that a recession may unfold over the next six to 12 months. But again, when we're thinking probabilistically, we're also trying to be very open to the idea that maybe central banks and authorities could orchestrate a soft landing. Maybe you don't want to get too defensive here and continue to have exposure to equities should that environment unfold. So it's a pretty neutral stance, and we continue to weigh the inputs, and we'll make changes as our conviction level changes.

[00:12:40] Andrew Johnson: Underneath that, one of the changes that I've obviously been talking to clients about throughout this year has been the introduction of the U.S. mid-cap asset class. What led to that decision, and what other potential changes are on your radar?

[00:12:51] Steven Visscher: Well, the U.S. mid-cap strategy was launched about three years ago, so that became another potential asset class to include in our balanced strategies. Now it doesn't mean it automatically happens on day one. There's typically a period where Greg, myself, and the other asset mix committee members observe every new strategy and look to fully consider how it might complement what's already in the balanced portfolio.

So after a fairly long period of observation in early 2024, we felt there was a compelling opportunity to shift a little bit of capital from our U.S. equity strategy, which is more heavily biased toward larger U.S. businesses, to this mid-cap segment. What led to that particular decision was just recognizing there was a valuation gap. We felt that by shifting from the U.S. strategy to the U.S. mid-cap, we could improve the valuation characteristics of the balanced portfolio and improve the overall diversification of our equity sleeve in the U.S. So that was predominantly what led to the introduction of U.S. mid-cap back in February.

We've subsequently continued to make incremental shifts. We did so again in June, and those continue to be ongoing discussions today about continuing to build that U.S. mid-cap allocation. There's one other asset class on our radar – global credit. This was a strategy that was launched in February of this year and had been on the firm's radar for a long, long time. The launch in February was an exciting moment for the firm. We've still been in that observation phase. From an asset mix perspective, global credit has not entered the balanced portfolio, but we've been very pleased with how the global credit team has seamlessly integrated with the rest of the research personnel.

There have been numerous examples of the global credit team leveraging the existing work of our Canadian bond strategy colleagues, as well as our colleagues in research across the equity platform. So that's all very positive,

and we're quite optimistic that global credit will be a real useful complement to our existing Canadian bond strategy and further diversify the 40% that we currently have in fixed income. Maybe when you have me on your show on a future date, we'll be able to talk about where global credit stands in the balanced portfolio.

[00:15:03] Andrew Johnson: Certainly diversification is the closest thing to a free lunch that we can ask for here in the investment world. This has been really great, Steven. Was there anything that we missed before we sign off?

[00:15:12] Steven Visscher: The last thing I'll leave you with is that we can spend hours talking about the risks, and there are so many potential pitfalls that lie ahead. But from a balanced perspective, our goal isn't to eliminate risk; it's to manage it. It's to ensure that we're being compensated for the risk that we're taking. It's to ensure that there are no sharp edges or unintended consequences in the balanced portfolio. So that's where we stand today.

We're in an uncertain world, but we're actually optimistic about the future. As I said, the potential returns from fixed income are greater today than they have been. We've alluded to the introduction of U.S. mid-cap strategy, and again, we're pretty intrigued with global credit and how that might also benefit portfolios. So, don't get too worried, don't get too stressed about risk, and don't get zeroed in on elections and interest rates. If you think and adopt a long-term perspective, there are a lot of positives to be had right now.

[00:16:05] Andrew Johnson: That's a great way to wrap up. Thanks again, Steven. I appreciate you coming on today.

[00:16:09] Steven Visscher: Thank you. Andrew. It's great to be on the show.

[00:16:11] Andrew Johnson: Hey everyone. Andrew here again. To subscribe to the Art of Boring podcast, go to mawer.com. That's M A W E R dot com forward slash podcast, or wherever you download your podcasts. If you enjoyed this episode, leave a review on iTunes, which will help more people discover the “be boring, make money” philosophy. Thanks for listening.