Building a Resilient Portfolio

to Withstand Market Stress

SYLVIA S. KWAN, PH.D., CFA, CAIA, CHIEF INVESTMENT OFFICER

Every investor looks smart when equity markets are rising. Optimism and confidence are the norm, and words like “risk” and “uncertainty” are concerns for another day. The much-touted benefits of diversification aren’t apparent, and diversifying your investments may even feel like a drag on returns when equities keep reaching new highs.

But when downturns, recessions, and whiplashing market volatility come, it’s a completely different story. They bring anxiety, panic, and uncertainty, causing us to question our tolerance for risk, and whether our investment plans and strategies are still working.

This is when investing can be emotionally taxing. Managing through downturns takes grit and can test the mettle of even the most experienced investors. We can’t control the markets and we can’t foresee the unpredictable! What we *can* do is build resilience into our investment process and our portfolios, so they can better withstand times of market stress. “Resilience” in this context means the ability to sustain downturns with potentially fewer losses — which enables a faster recovery when the markets turn upward.

Other firms may strive to create strategies that maximize returns (with associated risks) for bull markets. However, at Ellevest, we focus on building personalized portfolios to be resilient under different market environments, not just strong ones. And no, “resilient” doesn’t mean generating positive returns all of the time. That’s not possible if you are investing. Instead, it means a carefully crafted strategy where resilience is integrated into each specific asset class so that as a whole, the portfolio has the potential to perform in strong markets *and* endure during challenging economic conditions.

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What's the difference? Successful investing in the long run depends on how well your portfolio withstands the downturns — not how well your portfolio performs when markets are up.[1] Mitigating losses helps preserve the value of your portfolio so that it requires less time to recover during those downturns and has more capital for growth during strong economic times.

The key to building a resilient portfolio is prudently managing and mitigating risk. We can manage risk through proper and thoughtful asset class diversification. We can mitigate (not eliminate) risk within every asset class by carefully choosing investments with characteristics that are shown to reduce investment risk.

Mitigating risk is not necessarily synonymous with lower returns. In fact, studies show that reducing your losses on the downside can outweigh achieving gains on the upside.[2] And that ultimately means more successful outcomes over the long term.

Asset allocation

At Ellevest, we've always stressed the importance of diversification in a portfolio. True diversification means that over the long term, each type of asset class in your portfolio will behave in different ways under varying market conditions. Over shorter periods, it means some parts will be down while others are up; or that multiple parts are all up or all down, but at varying degrees.

[1] https://bit.ly/3m4ptXC and https://bit.ly/3o9fbr2

[2] https://bit.ly/31nrg1P and https://bit.ly/2TdgZ43

We believe that all portfolios should be diversified across global stocks, global bonds, and alternatives, which are other types of investments with diversifying risk and return characteristics. Each part of your asset allocation has a vital part to play in your overall investment strategy and building as much resilience as possible through intentional securities selection is how we build a portfolio that can stand the test of time, both good and bad.

Building resilience in equities

Global stocks are the long-term growth engine of your portfolio. While public equities bear the highest risks, they also offer the greatest potential for returns over the long run. When equity markets are strong, stocks will be the primary driver of your portfolio returns. But when equity markets take a downturn, or the economy falls into recession, inevitably your equity portfolio will suffer.

So how do we build resilience in an equity allocation? Not by trying to predict where we are in the economic cycle and choosing sectors we believe will outperform — nor by choosing defensive stocks or those that we believe will benefit in the short term. We've said it before, and the data backs it up: No one can reliably predict the markets, and tactical strategies for the short term have mediocre to poor outcomes.[3]

Instead, we seek companies across all sectors that have demonstrated strong and ethical governance practices, high environmental standards, and respectful and healthy relationships with their employees, vendors, customers, and community at large. Why? A growing body of research shows that companies with these characteristics have not only outperformed their peers — but have done so with *lower risk*.[4]

It stands to reason that high-ESG companies are the ones that are more likely to manage through challenging times. Stronger governance practices — and better relationships with their customers, suppliers, and employees — are more likely to help them weather a crisis and come out stronger on the other side. Crises and recessions have the tendency to accelerate the demise of struggling companies and prepare those that are stronger to thrive as economies recover. While it is impossible to completely inoculate an equity portfolio against market downturns, we increase its resiliency by investing in companies with resilience — those with high standards and

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[3] https://nyti.ms/3m1AmJv

[4] https://bit.ly/31lFNeu

sustainability measures, which historically tend to hold up well during times of market stress.

The global and very personal nature of the coronavirus pandemic has heightened our awareness of how companies manage risk, how they meet and balance the needs of employees, customers, vendors, and their communities, and how they navigate through extremely challenging times: in a word, how resilient they are.

Building resilience in bonds

Unlike equities, the purpose of holding bonds in your portfolio is wealth preservation and income generation. No one builds wealth by investing only in bonds, but when equity markets are weak, the bonds in your portfolio can help offset losses and balance out the risk of holding equities. Because this part of your portfolio is intended to preserve wealth, it’s important that the core of your bond allocation be invested in high-quality bonds and issuers with strong credits. These are the companies, municipalities, and other entities with the kinds of credit ratings that give us confidence that interest payments (and ultimately principal) will be paid, even during challenging economic times.

When equity markets are weak, the bonds in your portfolio can help offset losses and balance out the risk of holding equities.

For most of our clients, the bulk of a fixed income allocation is invested in individual municipal bonds. Historically, municipalities have had very low correlation to global equities and low default rates. Because they often (but not always) move in the opposite direction of equities, municipal bonds help offset losses in other areas of the portfolio when equities underperform.

While municipal bonds have historically experienced very low default rates,[5] we can still increase resilience and reduce risk by investing in bonds backed by essential services, like water, sewer, and education, or by state tax revenues backed by the full faith and taxing power of the issuer. We avoid bonds that depend more heavily on economic prosperity, like stadiums, hotels, and convention centers. While essential service bonds may not offer the highest yields, they are more likely to weather and perform during periods of economic stress. Because the role of bonds is preservation and not capital growth, it does not make sense to stretch for higher yields by assuming more risk in bonds. That's the purpose of equities.

Building resilience in alternatives

Alternatives — investments that are neither publicly traded stocks nor bonds — can play the most critical role in building a resilient portfolio. Alternatives can add risk-reducing diversification to your portfolio; they also offer sources of returns during market downturns. At Ellevest, we intentionally seek alternative investments with returns and risk characteristics that are not tied to public equities and bonds, so their primary drivers of return are not wholly dependent upon how stock or bonds perform, how the economy is faring, or whether interest rates or inflation are rising or falling. Instead, we seek alternative investments whose returns are driven by supply and demand imbalances that we believe will persist, whatever the health of the overall economy might be.

Alternatives offer sources of returns during market downturns.

Examples of such alternatives include renewable energy and direct real estate, particularly in affordable and median- to low-income housing. Because of their high sensitivity to the economy, we do not generally seek investments like hedge funds, private equity strategies such as buyouts or mergers and acquisitions, distressed debt funds, or high-end real estate. We also generally do not employ liquid alternatives strategies, due to their high correlation with public equity markets. These latter types of alternatives may be appropriate for different purposes in a portfolio, but don't have the qualities we seek in building resilience.

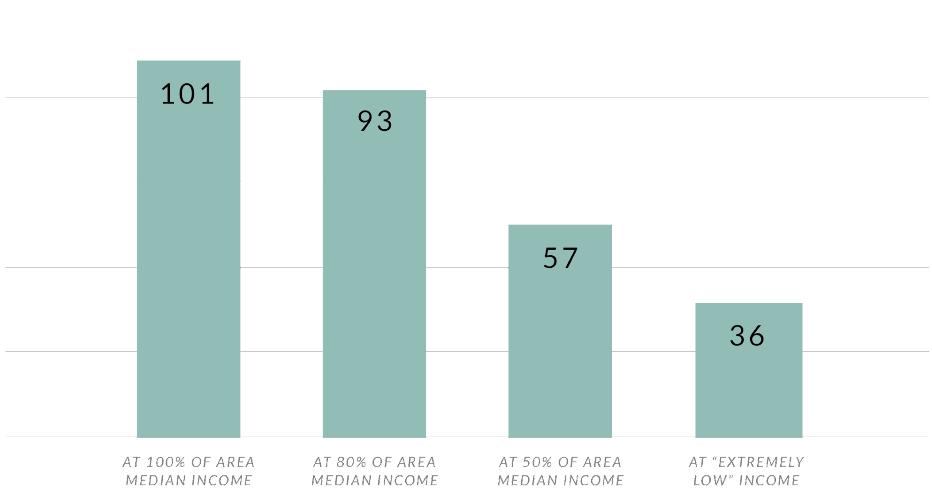
[5] https://bit.ly/3dSFHQR

Example: Affordable housing

To illustrate resiliency in alternatives, let's explore investing in affordable housing (housing with rent restrictions that are intended for low- and very low-income households). Today in the United States, we face a shortage in affordable housing, which will likely worsen as the homelessness crisis in the US grows.[6] At the same time, the supply of affordable housing continues to shrink, as fewer affordable housing developments are built, and as homes originally designated as affordable get acquired, renovated, and converted into market-rate homes.

CHART A

Available affordable rental homes for every 100 renter households



SOURCE: NATIONAL LOW INCOME HOUSING COALITION

This supply and demand imbalance will continue to widen regardless of how the economy is faring. In fact, recessions and market downturns — and most likely the coronavirus pandemic — exacerbate the demand for affordable housing even further. Studies show that historically, affordable housing has performed well during

[6] https://brook.gs/301aCii

recessions because its returns are driven by increasing demand and declining supply, *not* by the performance of stocks or bonds.[7] It is likely then that for the foreseeable future, affordable housing will be in demand, like an essential service, making it an investment that is expected to perform regardless of (or in spite of how) equity markets perform.

Example: Renewable energy

Another example of a resilient alternative investment is renewable energy: wind farms, solar, and hydro power. We believe the demand for green energy will continue to grow due to several factors: consumer demand and awareness of the environment, increasing regulation from governments and municipalities mandating reductions in carbon emissions, and an effort from corporations to reduce their carbon footprint and even become carbon-positive.

Over the past decade, the cost of solar panels has dropped significantly, making renewable power very price competitive with traditional energy sources. Solar has grown from less than 1% of the world's electric-power capacity to an estimated 9%.[8] By 2040, the International Energy Agency expects solar to be the largest single energy source.[9]

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Investing in renewable energy can be a low-risk, stable yield investment relative to equities. While it isn't expected to produce oversized annual returns, it also isn't likely to be subject to extreme market volatility. It generates power using natural resources that are readily available — sun, wind, water — so disruptions to supply chains are unlikely. And the demand for electricity that these energy assets produce is an essential service that isn't expected to ebb and flow with the equity markets.

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7 https://bit.ly/3dUYOtu and https://bit.ly/3joIORj

8 https://bit.ly/2TaGDWY

9 https://bit.ly/3dF0PtD

Alternative strategies like affordable housing and renewable energy can offer stabilization to your portfolio during times of market volatility and economic stress. As long as demand for the products and services from these alternatives continues (and grows), these investments are expected to continue to perform. Having allocations to these kinds of investments can increase the resilience of your overall portfolio and help your investments better weather times of economic stress.

Knowing that your portfolio was designed to maximize resiliency will not only help you weather the tough times but also help you stay the course with greater peace of mind.

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