ORION
PORTFOLIO SOLUTIONS

Preparing Clients for any Market Scenario

AN ADVISOR'S GUIDE TO MARKET CYCLE MANDATES

A CHALLENGING LANDSCAPE FOR ADVISORS

Some might say that driving sustainable growth within an advisory business has never been harder. With the rise of digital advice and regulatory scrutiny driving an increased demand for transparency, today's advisors face unique challenges in client acquisition and retention.

So how can you navigate this challenging landscape?

The answer does not lie in delivering heightened transparency and robust technology alone. It's found in understanding client expectations, and aligning investment strategies with those expectations to create a deeper advisor-client relationship.

A COMPELLING INVESTMENT STORY

Traditional thinking tells us that more than 93% of portfolio return variance can be determined through asset allocation strategy alone, as shown in the popular 1986 study, “Determinants of Portfolio Performance”. In a revised 2010 study, “The Equal Importance of Asset Allocation and Active Management”, Roger Ibbotson identified the major role played by short-term movement of the market. By considering the influence of market movement on asset performance, Ibbotson showed that, “asset allocation is very important, but nowhere near 90 percent of the variation in returns is caused by the specific allocation mix.”

Rather, he found that around 75% of overall portfolio return variance was driven by the cyclical movement of the market[1].

The 5-year rolling returns for two opposing allocation strategies [50% S&P 500/50% Agg and 100% S&P 500) are closely correlated - around 97% -regardless of asset allocation.

The data table and chart below reaffirm Ibbotson's study - emphasizing the influence of market movement.

	50% S&P 500 50% BB Agg	100% S&P 500	
Year	5 Year Return	5 Year Return	5 Year Correlation
1994	8.32	8.7	0.98
1995	13.09	16.59	0.96
1996	11.13	15.22	0.95
1997	13.82	20.27	0.97
1998	15.63	24.06	0.97
1999	17.99	28.56	0.97
2000	12.59	18.33	0.98
2001	9.5	10.7	0.98
2002	3.93	-0.59	0.98
2003	3.41	-0.57	0.97
2004	3	-2.3	0.97
2005	3.54	0.54	0.96
2006	5.88	6.19	0.95
2007	8.67	12.83	0.92
2008	1.4	-2.19	0.96
2009	2.99	0.42	0.98
2010	4.44	2.29	0.98
2011	3.54	-0.25	0.98
2012	4.26	1.66	0.98
2013	11.36	17.94	0.98
2014	10.09	15.45	0.98
2015	8.02	12.57	0.97
2016	8.44	14.66	0.96

Source: Rocaton Investment Advisors

WHY FOCUSING ON MARKET MOVEMENT IS RELEVANT

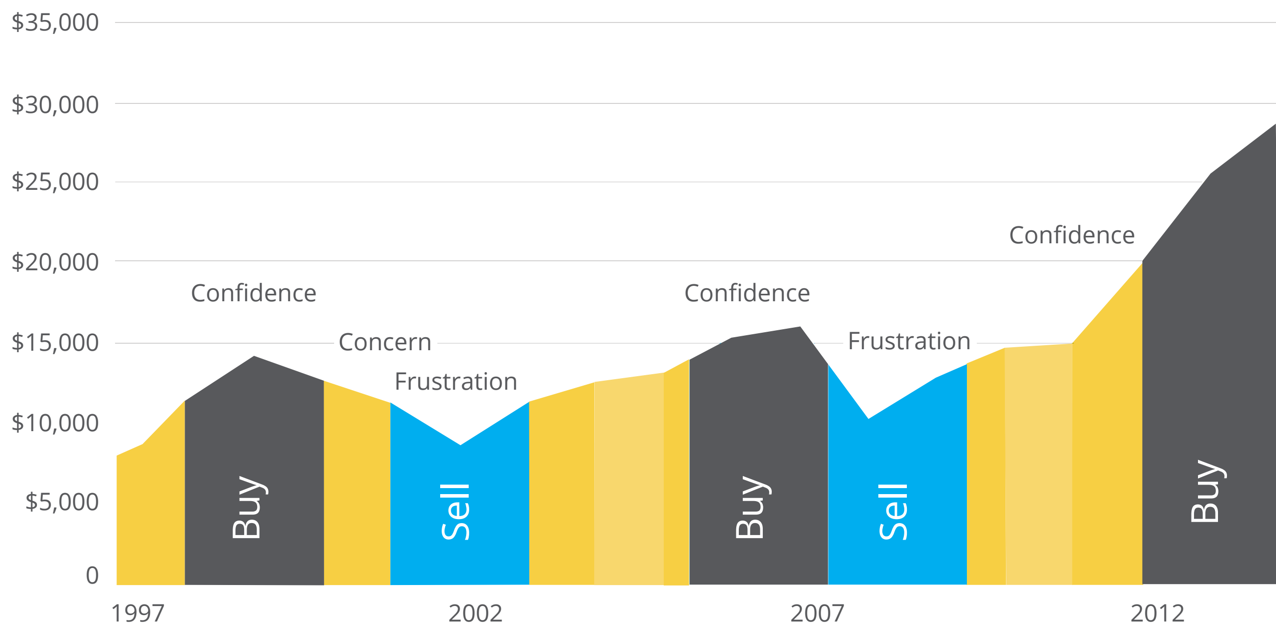
The market is often filled with uncertainty. This lack of clarity can cause clients to take more risk than anticipated at market peaks and less at market bottoms – led from a natural aversion to risk. As the market fluctuates, so do client emotions. Confidence grows at market peaks and falls as returns trend negative. Without an eye toward market movement and clear understanding of a client's desired degree of market exposure, portfolios can easily become misaligned.

Advisors that help clients better understand and prepare for market influences are positioned to more accurately align client expectations to realistic portfolio outcomes – a leading challenge facing advisors today[2].

Cycle of Investor Emotions

Growth of $10,000

S&P 500

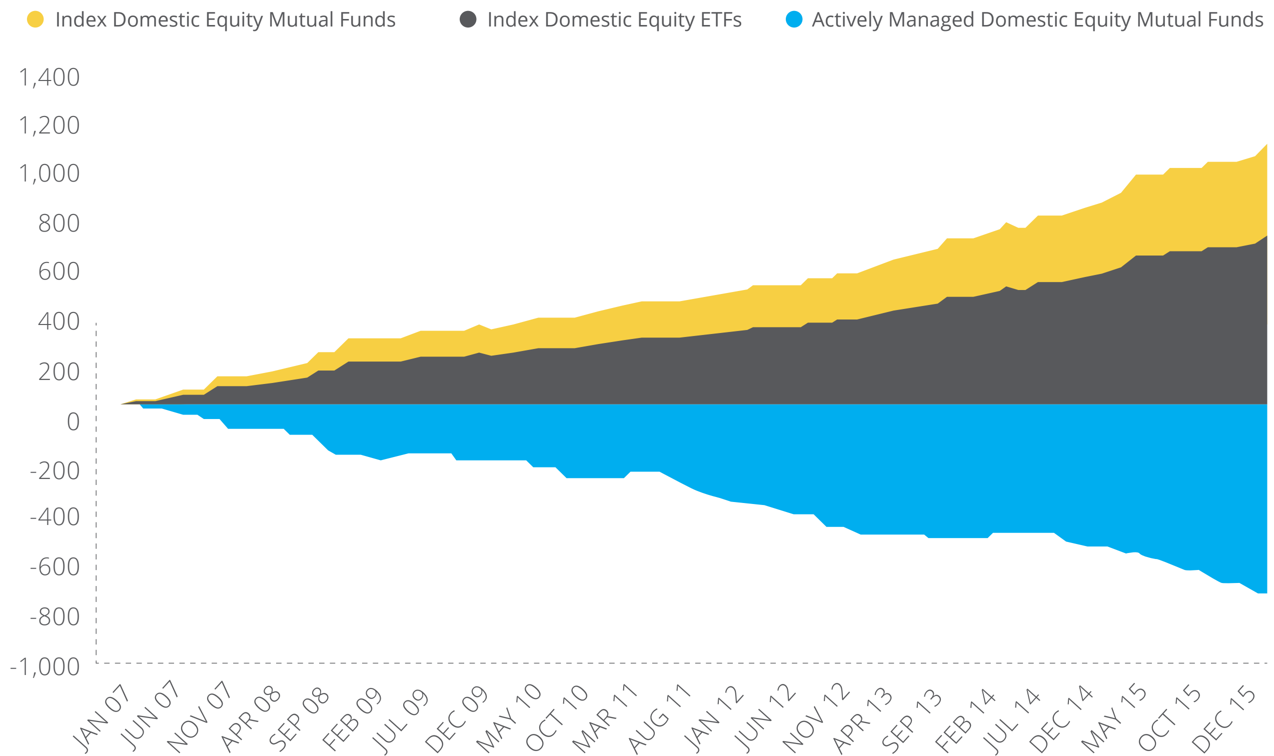


MARKET PARTICIPATION TRENDS UPWARD

Since the 2007/2008 financial crisis, we've seen investors flock toward market index-oriented investments. As expected, strong market growth has led to an increase in investor confidence. A perceived decrease in risk may cause portfolio decisions to deviate from more aligned market exposure preferences. But it's important to remember (and communicate) that market influences on portfolio returns can move both ways.

Some of the Outflows from Domestic Equity Mutual Funds Have Gone to ETFs

Cumulative flows to and net share issuance of domestic equity mutual funds and index ETFs, billions of dollars; monthly, January 2007 – December 2015



Note: Equity mutual fund flows include net new cash flow and reinvested dividends. Data exclude mutual funds that invest primarily in other mutual funds.

Source: Investment Company Institute

What happens when the market shifts? Misaligned allocations are often revealed in the transition. And while you can't manage out of market cycles, you can better align the portfolio to a client's expectations.

It begins with asking your clients timely and specific questions.

3 QUESTIONS TO UNDERSTAND CLIENT EXPECTATIONS

Risk tolerance questionnaires are a requirement in our industry – an essential first step to building portfolios within a client's risk tolerance and comfort level. However, general questionnaires often neglect to consider client behaviors in various market conditions. A fundamental disconnect can be created between expected outcomes and realistic performance.

Fortunately, closing the gap is easy. Amend your risk questionnaire with targeted questions that easily uncover unique perceptions and expectations within varying market environments – growth, volatile, and declining.

Growth Market Cycle

- **Ask** — Global markets, though volatile, have historically been great engines of long-term wealth creation. Should a portion of your portfolio be exposed to the returns and volatility associated with these markets?
- **What It Tells You** — The answer gives you an overall understanding of a client's view of the market. Those that want exposure are more likely to tolerate negative returns in falling markets, understanding risk vs. reward. They will also demand a more aggressive return profile when markets climb.

Volatile Market Cycle

- **Ask** — Would you expect a portion of your portfolio to be actively managed during periods of market volatility?
- **What It Tells You** — The answer helps you understand a client's expectation of active management. Those that opt for active management will expect stronger returns in market volatility, expecting value from dedicated guidance.

Declining Market Cycle

- **Ask** — Should a portion of your portfolio be excluded from market movement during periods of market declines?
- **What It Tells You** — The answer measures the client's aversion to market risk. Reducing the client's market exposure and/or including low or negatively correlated products like alternative investments can address this need. Declining any degree of exclusion shows acceptance of full market movement, requiring less insulation from volatility.

These questions are simple, yet they provide invaluable insight into client expectations. Added to your risk tolerance questionnaire, they inject an additional layer of clarity into the investment process, creating a common ground between you and the client. With full disclosure and awareness of their investment attitudes, they can be better assured that each investment decision will align directly with those preferences.

HOW TO CONSTRUCT PORTFOLIOS FOR MARKET MOVEMENT

Once you've established a common ground with your clients, you can construct targeted portfolios that seek to deliver a positive investment experience that is independent of market trends. Blend three distinct mandates (strategies) for desired market participation and risk/return profile.

Beta Strategy

With similar risk-reward profiles to broad U.S. stock indices, exposure to Beta Mandate assets provides a portion of an investment portfolio to full market participation.

- **Source of risk/return:** Dependent on market direction, less reliant on active management.
- **Role in portfolio:** To Capture and fully participate in market returns for long-term growth.

Stractical Strategy

Active Mandates have been a focal point of the industry, following positive performance in the 2008 financial crisis (allegedly). Though it is easy to treat Active strategies as the perfect middle ground between Beta and Diversifier strategies, it is best suited as a complimentary component within a blended investment portfolio.

- **Source of risk/return:** Increasingly dependent on active manager decisions, seeking variable market exposure.
- **Role in portfolio:** Moderate/flexible allocation designed to actively manage risk while opportunistically seeking attractive asset classes.

Diversifier (Liquid Alternatives) Strategy

Diversifier strategies that have little or no correlation to Beta and Active mandates. This is a replication of pension plan investing through inclusion of non-correlated funds/strategies – providing an attractive way to manage risk.

- **Source of risk/return:** Highly active strategies using wider spectrum of asset classes and strategies with minimal dependence on market direction.
- **Role:** Counterbalance mandate 1 to improve overall risk management of portfolios.

Example

THE INVESTOR

55 years old (short time horizon) / $600,000 portfolio

Risk Category: Balanced

Wants a portion of assets to experience full market participation

Expects investments to be actively managed in volatility

Expects a portion of assets to be excluded from declining markets

Blend

35% Beta / 40% Active / 25% Diversifier

This portfolio seeks to deliver expected market participation through an aligned risk profile.

A moderate allocation in Beta helps provide the desired market performance and helps create a risk vs. return profile that is well suited to achieve growth against a short time horizon.

With substantial Active Beta and Diversifier allocations, the portfolio also seeks to deliver an expected level of active management and insulation from shear market vulnerability. These allocations further target select growth opportunities that are balanced with dedicated risk mitigation – an increasingly important component as investment goals shift from growth to capital preservation.

HOW TO REINFORCE YOUR STRATEGY

While primed for success, your market-focused investment strategy should be reinforced Transparency and validation in the investment process are key to maintaining client satisfaction.

First, it's important to set up regular investment reviews if you do not have them in place already.

A good rule of thumb is to meet quarterly, unless there is a major market issue.

Dedicated meetings give you an opportunity to validate your investment story to each client. Track investment performance by each unique mandate referenced above. Segment returns by mandate, and discuss how each strategy plays a specific role in the portfolio.

PERFORMANCE REPORTING

Past performance is not indicative of future returns, but if used to show stability through market fluctuations, it can provide validation.

Show the client how this blend of strategies delivers a return profile appropriate for the specific market cycle it inhabited. When referencing historical data in current review meetings, your prior segmenting of each mandate, or strategy, becomes even more important and relevant. Talk about the role each mandate might have played if market conditions had changed, expressing the importance of avoiding subjective decision making based on recent trends and short-term performance.

It's also important to proactively monitor the risk profile of each investment. As the market moves, so can the return variance for a portfolio's underlying assets. Consider integrating embedded risk scoring capabilities for each investment strategy. Actively monitoring each asset's risk profile helps you better manage the client investment experience, increasing your ability to maintain a consistent level of risk through volatility.

Reg.Type	Custodian	Account	Strategist	Mandate	Value	Quarterly Performance
Traditional IRA	**TD Ameritrade**	**1234**			**$475,881**	**8.33%**
		1234_1	**Vanguard CRSP 60% Equity 40% Fixed Income**	**Beta**	**$190,843**	**6.24%**
		1234_2	**AAMA Global Growth ETF**	**Active**	**$237,576**	**9.94%**
		1234_3	**Toews High Income**	**Diversifier**	**$47,462**	**8.69%**

MONITORING AND ONGOING DUE DILIGENCE

Monitoring can be achieved manually, or through a third-party partnership. Consider the amount of time you and or your staff have available to monitor your investment strategies. Do you have a dedicated resource to monitor each strategy?

If not, consider the following outsourcing options.

- **Investment Advisory Firms –** direct and customizable partnership with a specialty firm. Outsourcing to a dedicated consultant eliminates internal monitoring workloads.
- **Software Applications –** pre-packaged investment monitoring applications. As is normal in today's digital environment, an expected rise in fintech will increase the availability of packaged software solutions. Integrating off-the-shelf technology helps you streamline investment monitoring workloads in-house.
- **Turnkey Asset Management Programs -** a holistic investment and back-office solution. Partnering with a turnkey program gives you access to more comprehensive investment services, from access to third-party strategists to fullservice back-office solutions, including automated reporting and fee billing.

IMPACT ON YOUR PRACTICE

An objective strategy can not only help you better connect to prospective clients with a compelling investment story, it can also help you better prepare clients for uncertainty, aligning their expectations of the investment experience with the reality of moving markets and volatility.

Focused on market movement, rather than individual asset class modeling, you and your clients can better prepare for every market scenarios. You will enjoy the benefits of differentiation in an increasingly commoditized industry and more easily drive long-term growth with leading client attraction and retention.

Sources

[1]The Equal Importance of Asset Allocation and Active Management, April 2010

[2] Capital Group Advisor Survey, June 2016

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2300 Litton Ln. | Ste. 102 | Hebron, KY 41048
P 1.800.379.2513 | F 1.859.426.2050
www.orionportfoliosolutions.com

0006-OPS-5/23/2019