Brown ADVISORY
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A PUBLICATION OF THE ADVISORY

ASSET ALLOCATION

A MOMENT OF ZEN: THE WISDOM OF STAYING INVESTED

From high valuations to geopolitical fault lines, warning signals about the market are seemingly everywhere, and some investors are thinking about getting out of the market and "going to cash." But investing should not be about impulsive decisions—it requires contemplation, focus, discipline and patience.

When discussing the merits of cash as an investment, Warren Buffett doesn't pull his punches, saying that those who hold cash or its equivalents "have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value."

We strongly believe that clients should hold an appropriate reserve of cash for operating needs and emotional security. But we view that cash as a management tool—we agree with Warren that the investment merits of cash are lacking. As true as that may be, investors are all vulnerable to the fears of the moment, and some may seek the comfort of pulling investments from a frothy market and "going to cash." Of course, it's possible that going to cash might work for you—assuming that your goal is short-term outperformance (that is not our goal) and that you can predict the market's short-term movements (we do not believe this is possible).

We are long-term investors, focused on plans that help our clients pursue their long-term goals. But we can't deny the existence of fear. Fear is certainly understandable in today's environment. Valuations of the U.S. and global stock markets are elevated, reflecting a global bull market well into its eighth year. The U.S. and global economies have managed to eke out decent performance in recent years but have yet to re-establish their pre-crisis growth levels. And we face geopolitical risks seemingly in every corner of the globe.

These may feel like justifiable reasons to exit the market, but remember that the worst investment decisions are often driven by irrational short-term fear (or its equally dangerous cousin, irrational greed). It is rarely wise to make impulsive or reactionary investment decisions; we believe that every action in a portfolio should fit into a disciplined program with clear long-term objectives in mind. Adjusting cash levels, just like any other investment decision, should only take place after careful consideration and always in the context of a long-term plan.

ALL OF THIS HAS HAPPENED BEFORE

If investors think they face uncharted territory, they are more at risk of taking extreme actions, like pulling out of the market entirely. Today, we hear the word "unprecedented" far too often, referencing everything from stock valuations, to the U.S. political environment, to the situation in North Korea.

We find that when trying to stick to a plan for the future, it helps to study the past. In truth, most decades in recent history have been filled with notable conflicts, stresses and fears that, at the time, may have seemed like "unprecedented" conditions for capital markets.

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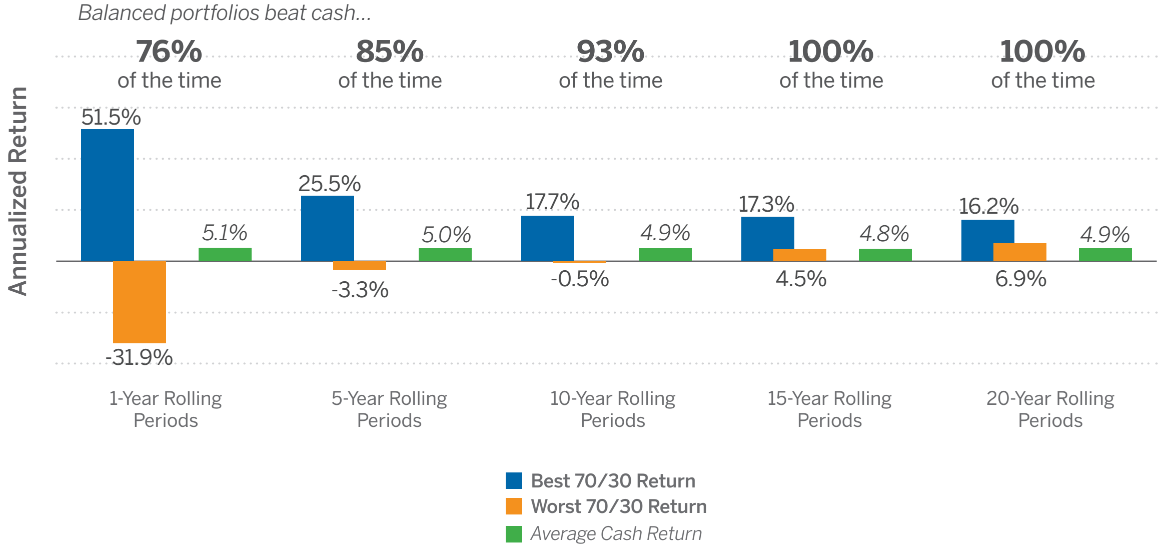
But the market has proven quite resilient in the face of these conditions, providing ample returns to investors from decade to decade. (The notable exception is the period between 2000 and 2009, a decade that contained not just one, but *two* of the biggest market crashes since the Great Depression.) In the 1960s, the S&P 500® Index averaged a 7.8% annual return while it grappled with massive civil unrest, Cold War nuclear politics, the Vietnam conflict, and the assassinations of Martin Luther King Jr. and both John and Robert Kennedy. In the 1980s, it averaged 17.3% annually while weathering a deep recession early in the decade, the 1987 Black Monday market crash and the geopolitical instability brought on by the fragmentation of communism.

The most important thing we learn from history as investors is the opportunity cost of not being invested. Whenever a client is tempted to take money off the table, we always try to reinforce this notion. In the chart below, we looked at the rolling returns of balanced portfolios over various time frames (i.e., all possible one-year periods, all possible five-year periods, etc.) between 1979 and 2017, and then compared those results to cash returns over the same periods to see how often the balanced portfolio outperformed cash. The results over shorter periods showed a great deal of variance, but even in one-year increments, the balanced portfolio beat cash more than three quarters of the time. Over longer periods, returns were less volatile, and more

Stay the Course

We looked at data from the past several decades to try and answer two questions: What were the best and worst results produced by balanced portfolios over time? And how often did balanced portfolios perform better than cash? We found that balanced portfolios usually performed better even over shorter time periods; over longer periods, the balanced portfolio *always* beat cash.

70/30 BALANCED PORTFOLIO VS. CASH
Rolling Return Analysis (1/31/79–6/30/17)



Source: Bloomberg. 70/30 portfolio returns were modeled using the S&P 500 Index for stocks and the Bloomberg Barclays Aggregate Bond Index for bonds. Cash returns were modeled using 90-day U.S. Treasury Bills. Please see the back page of the publication for a complete list of terms and definitions.

importantly, the balanced portfolio always won out in the end over cash. So if you are trying to achieve long-term goals, history tells us that it pays to stay invested.

Beyond the story told by this historical information, holding investments for longer periods carries other benefits. The power of compounding should work to your advantage when investing for the long term, whether that means backing a solid company and benefiting from its business growth over time, or collecting and then reinvesting dividends and interest collected from income-generating investments. Additionally, long-term investors generally realize fewer gains in any given year than those who buy and sell frequently, which in theory should lead to reduced taxes over time.

PRACTICAL LONG-TERM INVESTING

Of course, long-term investing requires a more thoughtful approach than simply flipping an "in the market/out of the market" switch. In our experience, keys to success include **proper reserve planning, incremental positioning, truly diverse portfolios and measuring investments with the proper metrics.**

Reserve planning. If you want to commit fully to a long-term investment plan, you must first ensure that you have ample cash reserves on hand. Otherwise, you may find it tempting or necessary to dip into long-term investments—you may need the cash to fund short-term obligations, or you may simply want cash on hand for a greater sense of comfort or emotional security.

We spend a great deal of time making sure that we get this right with each client, and the equation is not a simple one. Part is objective, determined by each client's inflows from interest, dividends and other sources, vs. outflows for tax payments, required distributions or voluntary withdrawals for spending needs. Equally important is the subjective part of the equation, determined by the client's emotional orientation and how they perceive risk. Moreover, clients have different perspectives when it comes to keeping "dry powder" on hand so they can take action when the market presents an opportunity. All of these factors must be discussed and, importantly, they need to be re-evaluated periodically because no client's circumstances remain static over long periods of time.

Incremental positioning. One benefit of a balanced portfolio is the ability to adjust its various components over time—rather than jumping in or out of markets, we can lean one way or the other to express intermediate market views, while remaining true to long-term plans. For example, the market faces some legitimate challenges today—relatively high valuations, an aging bull market and geopolitical stresses that have yet to impact capital markets notably. While we do not want to act rashly, we can move portfolios into a more conservative positioning by trimming exposure in higher-risk markets and adding to core fixed income and other safer investments. Conversely, in the aftermath of the 2008–09 credit crisis, we were able to benefit by moving to a more proactive posture, overweighting U.S. equities and investing opportunistically in oversold asset classes.

Truly diverse portfolios. Most investors understand the benefits of diversification—if you do not want to be overly exposed to a specific market risk, such as a stock market downturn, then it's important to be invested in a variety of investments that are sensitive to a variety of different risks. Unfortunately, many investors end up selecting investments that appear to be diverse but don't actually produce diverse results.

We try to make sure our clients' portfolios are truly diversified with noncorrelated assets—in other words, spread across asset classes, geographies and styles, in different investments whose results are somewhat independent from each other. Not every investment in these portfolios is going to perform well at all times, but the goal is to ensure that in any given market situation, some investments lead when others lag.

In the post-crisis era, diversification has been somewhat elusive in public markets. Many investments that previously offered lower correlation—for example, U.S. stocks vs. non-U.S. stocks—have become much more synchronized. If you are able to invest in them, private/partnership investment options can greatly increase your portfolio diversification. Some hedge funds balance long and short investments to net out risk from stock market volatility, while private equity and real estate funds generally do not follow the same rhythm as public markets.

Using the proper metrics to judge investments. We devote ample resources to investment research at Brown Advisory, but when making decisions in client portfolios, all of that research can be for naught if we don't use it to answer the "right" questions. At any given time, some asset classes and managers will be driving the performance of the overall portfolio, while others will be dragging on performance. As prudent advisors, we always pay attention to underperforming investments, but to make effective decisions about them, we need clear views on how we *expect* them to perform under various market conditions, and whether their current performance matches our expectations. If an asset class or manager is underperforming when expected, it likely makes sense to stay the course. An example of this might be if a defensively oriented manager underperforms during a strong market rally; you would expect that style to produce that result. If an "expected" dislocation is large enough, it may in fact be an opportunity to add to a position at a favorable price. But if the investment is not performing as expected—for example, if a fund intended to offer protection in down markets is not doing so—or if conditions have changed materially, then it makes sense to revisit our investment thesis and potentially reallocate capital.

All of these tools have one thing in common: They help us practice the discipline and patience needed to avoid acting on reflex. Decisions like bailing out of the market and "going to cash" may provide comfort in the moment, but generally they do not pay off in the long run.

The **S&P 500® Index** represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include market capitalization, financial viability, liquidity, public float, sector representation and corporate structure. An index constituent must also be considered a U.S. company. Standard & Poor's, S&P, and S&P 500 are registered trademarks of Standard & Poor's Financial Services LLC ("S&P"), a subsidiary of S&P Global Inc. measures the performance of the small-cap segment of the U.S. equity universe.

The **Bloomberg Barclays Aggregate Bond Index** is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. Bloomberg Barclays Indices are trademarks of Bloomberg or its licensors, including Barclays Bank PLC.