Market Pulse Report

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PATHSTONE
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SUMMARY

It would not be surprising to see volatility land a few punches on the markets later this year, so now is not the time to get too aggressive with regards to portfolio allocations. But the economy is still relatively fresh and not likely to go down for the count, so it is not yet the time to throw in the towel on growth-oriented investments. If stocks take a hit, try to roll with the punches and look for any new opportunities.

Protect Yourself at All Times

The recent mega-fight between legendary boxer Floyd Mayweather and mixed martial artist Conor McGregor put quite a spotlight on the boxing world. And whether you are a fan of the "sweet science" as boxing is often referred to, or think the pugilistic sport is rather barbaric, the event was quite a spectacle. It also reminded us that in many ways boxing, although violent, can make for an appropriate analogy to investing. Both are skillful crafts that involve strategy and forethought.

Balancing Offense and Defense. Boxing is more than just throwing punches, just as proper investing is more than just picking stocks. The idea of risk and reward is inherent in both endeavors. The fundamental purpose of boxing is to hit *and* not get hit. That is also a key tenet of our investment philosophy—we strive to generate portfolio growth while at the same time avoiding unnecessary losses.

Unfortunately, the opponent (whether another boxer or the capital markets) is almost always coming out swinging. It is not secret that in boxing, in order to be within range to hit your opponent, you must also be close enough to get punched yourself. Sometimes that can be a painful tradeoff. Likewise, investment theory dictates there is no reward without risk. For most portfolios, one must be willing to occasionally incur short-term volatility in order to generate appropriate returns. That typically means having a healthy dose of stocks and other growth-oriented assets—which of course come with the possibility of losses.

But too often, in both boxing and investing, participants can get focused on the prize and let their guard down. Going all-in on offense, swinging wildly and leading with your chin with little regard for protection, puts one at risk of being knocked out. For successful prize fighters and investors alike, defense is a priority. You do not want to get floored or suffer a catastrophic loss from which you are unable to recover. Since there is always the risk of getting hit with a devastating punch, the number one rule in boxing is to protect yourself at all times.

While defense in boxing includes keeping your guard up, bobbing and weaving, blocking and slipping punches, defense with regards to investing includes proper diversification into assets that may keep their value even if some of the offensively-oriented ones are losing theirs. Typically, this means complementing growth assets (stocks) with stable ones (bonds). Some investment strategies (such as active management and long/short hedge funds) can protect on the downside, while others such as structured notes, are even meant to protect on the downside while keeping a portion of the upside intact—talk about balancing offense and defense! Too much defense, however, can also limit the odds of success. Just as boxers need to eventually throw some punches in order to win, allocating solely to cash gets investors next to nowhere.

Ring generalship, or maintaining just the right amount of effective aggression, is key. Boxers want to stay on their toes, throw clean punches, but be hard to pin down—they do not want to get stuck in a corner on their heels up against the ropes. A skilled prize fighter dictates the pace, style, and position within the ring to their advantage. Likewise, investors need to be keep an eye on prudent opportunities, but not be so aggressive (succumbing to hot fads, leverage, or following the herd) as to get trapped by illiquidity or counterparty risks when things get rough. Through thoughtful allocations, appropriate diversification, and prudent manager/security selection, investors can exhibit "portfolio generalship" and position themselves for long-term success.

Mix it up. A successful boxer doesn't just throw bunches of punches. He/she may start with a jab, followed by a cross to the head or a hard shot to the body. There are all sorts of punches, including hooks and uppercuts, and combinations (a variety of punch-types thrown in succession from several angles) are often most successful. Furthermore, a southpaw (left-handed) stance can also be mixed in with an orthodox (right-handed) approach in order to confuse an opponent.

Likewise, in investing, relying solely on one punch such as a static, traditional U.S. stock/bond allocation may be suboptimal. A healthy dose of international equities and the use of alternative, uncorrelated strategies (hedge funds and private equity) can create new punching angels and be of long-term benefit. Stance and style also can be fluid— sometimes it pays to be more aggressive, sometimes keeping your distance and being a counterpuncher works best (taking advantage of downturns), and sometimes it is necessary to clinch or cover-up and not do too much (conserving energy/capital for later rounds).

Stick with it. Don't get discouraged and stray from your game plan, even if your opponent lands a few lucky (or inevitable) blows. You cannot always see where the next hit is coming from, and on occasion well-thought out strategies might not seem to work for a round or two. Even the best investors find themselves on the ropes on occasion. This usually rectifies itself as the fight goes on, as superior tactics and skills prevail in the end. Circle and counterpunch, clinch if you must, but do not throw in the towel at the first sign of adversity. Be a great contender like Warren Buffett—remain disciplined, roll with the punches (take what the market gives you), and step in with a big combination of power shots when an opening presents itself.

Gain an advantage. Just a prize fighter trains relentlessly to gain an advantage over an opponent, we also strive in the investment world to improve the odds of success. While a boxer may work to improve footwork and hand speed in advance of a fight, we continually monitor the investment landscape in search of asset classes we determine to be undervalued (and to reduce exposures to those deemed to be overvalued). We also seek to uncover asymmetrical return opportunities, which are occasionally available in non-traditional strategies.

While in the fight, it also pays to listen to your corner (manager/advisor) and make tactical adjustments as necessary. Just as a boxer may change things up to find better punching angles, we will modify positions as fundamentals dictate. If the situation calls for it, we will play more defense. This could be the case if the economy and corporate earnings start to deteriorate. We always try to think about the next round and be more aggressive when the odds are in our favor.

Summary. Investors have not taken a hard hit for some time, and it feels good to be up on the scorecards. But the equity markets always have the potential to land a sucker punch, and getting hit in the face hurts. Given extended valuations across a variety of asset classes, now might not be the time to fight above your weight (take on too much risk for your tolerances). But given low odds of recession, the bull market may still have some fight left in it. Now is not the time to sacrifice all forms of offense (growth-oriented exposures). Balance offense and defense, stay on your toes, listen to your corner, and be willing to make tactical adjustments as necessary. And by all means, keep your defenses up.