Five Strategies for a Sideways Market

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If this slow growth environment coupled with asset price volatility continues for (to steal a quote from Fed Chairman Bernanke) "an extended period," what additional portfolio strategies might aid the overall risk/return profile of investor portfolios? More specifically, how do you manage investments in a sideways market?

Adding to the complexity of these questions is the uncertainty about whether inflation or deflation poses more of a risk going forward, whether corporations are overvalued or undervalued and, perhaps most critically, whether the U.S. will double dip into recession or if this is this merely a normal mid-cycle slowdown.

Clearly, there is a wide array of scenarios being debated among economists and strategists, and the outcome has large implications to portfolios. The likely outcome – one that has been playing out for much of 2010 and 2011 – is a market that, while volatile, grinds sideways for a long period of time.

In his 2007 release of Active Value Investing: Making Money in Range-Bound Markets, Vitaliy Katsenelson laid out a compelling case for a long enduring sideways market as the high valuation extreme reached in 2000 gave way to a secular decline in P/E ratios that is still occurring today. Valuations have been declining for 11 years! This isn't new. Rather, this phenomenon has occurred fairly consistently throughout the history of the stock market.

Just consider the S&P 500 over the last decade. Earnings per share doubled, yet the market is lower than it was 10 years ago. This is because the price you pay for a dollar of earnings (i.e., the P/E ratio) has gone down. While the market looks fairly cheap on a forward-earnings basis, 10-year normalized earnings do not. Further P/E contraction in the future will only enhance the probability of a sideways market going forward. More on this can be found at activevalueinvesting.com.

Here are five imperatives for constructing portfolios for the sideways market ahead.

Strategy 1: Know the role of cash

Cash may have a place in a portfolio, but investors need to accept that *cash is a negative real-return investment*! Unless deflation takes over, cash will offer negative real returns until mid-2013. Bernanke has told us as much, since mid-2013 is the earliest targeted end date for the Federal Reserve's near-zero short-term interest rate policy. Bank accounts, CDs and money markets currently yield less than inflation, so simply sitting on cash is a losing proposition for investors seeking positive real returns over time.

Should cash be avoided completely? No. Cash serves a purpose. Its value doesn't fluctuate in nominal terms, and for people who are near or in retirement, the stability of cash has value above a simple interest rate. Understand, though, that this view of cash is from the planning perspective, not the investment perspective. If a client needs six months or two years of cash on hand, they should have that cash available regardless of the investing environment.

Looking at cash as an investment is different. Because cash currently earns a negative real yield, there is an investing cost to holding it. At the same time, holding some cash allows investors to take advantage of market opportunities as they arise.

Strategy Considerations

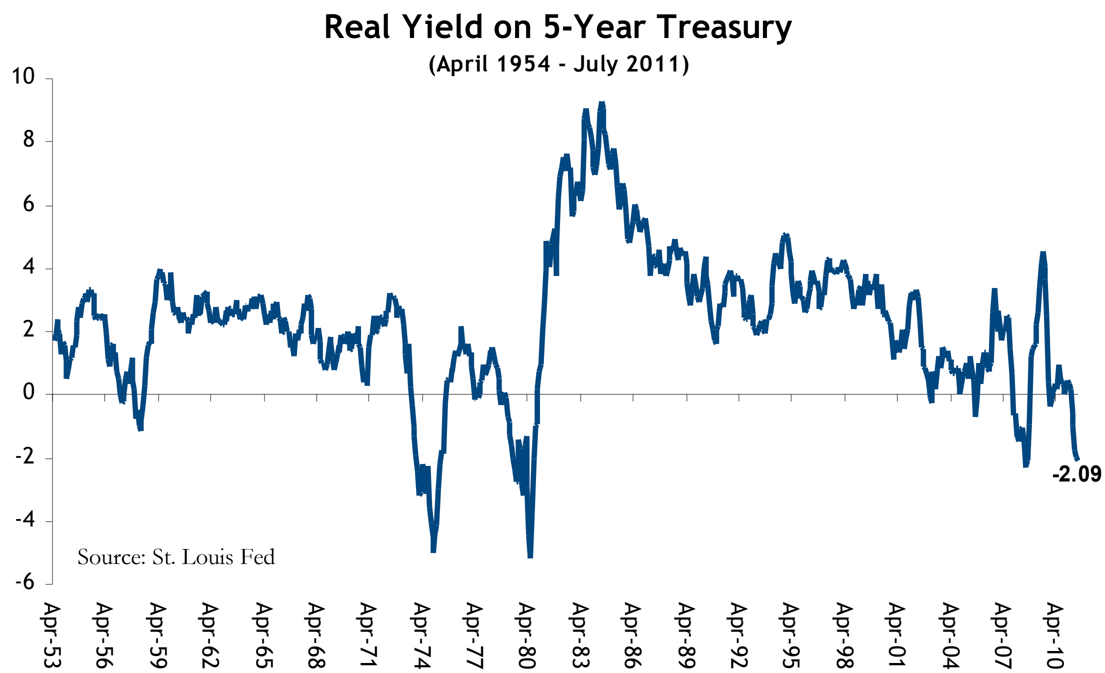
There are alternatives to cash, but for the most part they lack FDIC guarantee and stability of principal. There are some high-yield savings accounts that offer FDIC insurance and principal stability (as Jerry Stiller's commercials for Capital One promise) that pay savers around 1%, but of course, those rates are variable and lower than the inflation rate.

For those willing to take on the risk of shedding FDIC insurance and principal stability, some high-quality, ultra-short duration bond funds are worth a look. Look for funds that are liquid and have reasonable short-term redemption clauses. We have successfully implemented RidgeWorth U.S. Government Securities Ultra-Short Bond (SIGVX), which currently has duration of about 0.8 and a yield above 1%. It doesn't beat inflation, but it's better than most cash alternatives, especially money markets, albeit with the risk of no FDIC insurance.

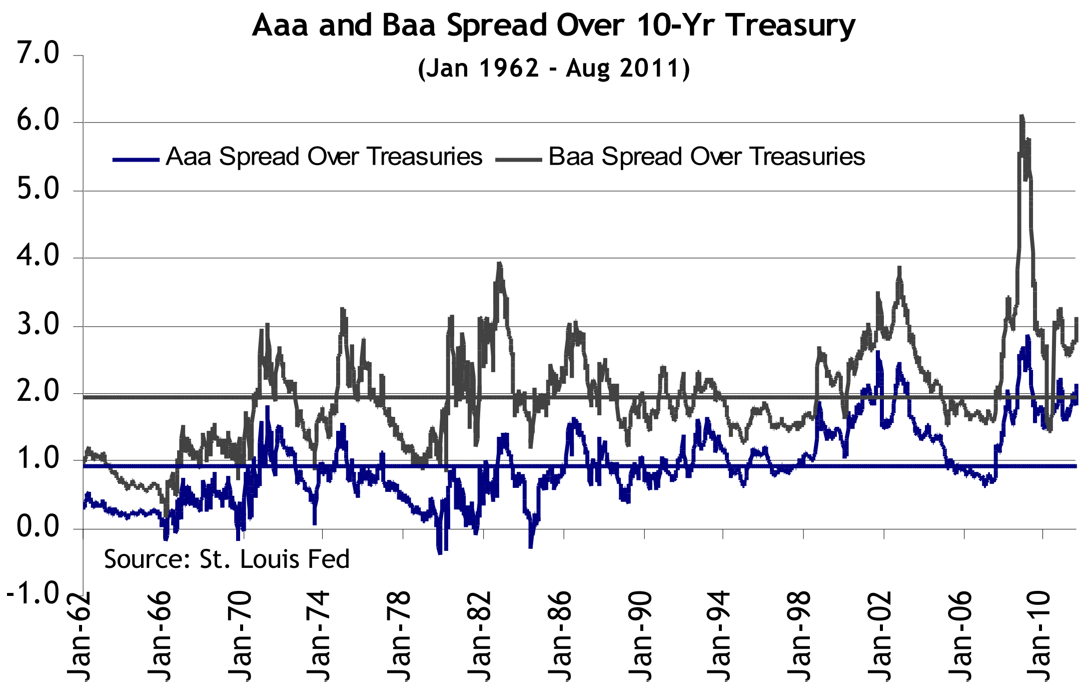
A similar product that is available in ETF form is PIMCO Enhanced Short Maturity Strategy (MINT). As with any ETF, investors should not pay a premium market price over NAV and must be mindful that principal protection (or NAV stability) should be a top factor when selecting any cash alternative.

Strategy 2: Seek spread for real yield

In PIMCOs June 2011 Investment Outlook, Buy Cheap Bonds with Safe Spread, Bill Gross made a similar case to ours above, namely that cash and Treasury bond investing offers negative real returns very far out on the yield curve. The chart below plots real yield on the 5-year constant maturity Treasury. As of July 2011, that real return against CPI-measured inflation is negative. Looking at future inflation implied by TIPS yields against Treasury yields, one must go out 10 years on the Treasury curve to achieve a real positive yield of only 0.25% (as of August 24, 2011).



So where is there positive spread? Corporate bonds (investment-grade and high-yield), emerging-market debt and some mortgage-backed securities offer positive spread with risks that we view as reasonable given the expected returns. The chart below shows the yield spreads of Moody's Aaa and Baa indexes over the 10-year constant maturity Treasury. The horizontal lines mark the historical spread.



With a 312 basis-point spread over Treasuries and a 100+ basis-point premium over its historical average, the Baa index (low end of investment grade) offers positive spread. Even the cream of the crop Aaa-rated investment-grade index offers a 200 basis-point spread over Treasury bonds and almost 100 basis points over its historical average. There is always a degree of principal risk, but the risk is currently being rewarded in our opinion.

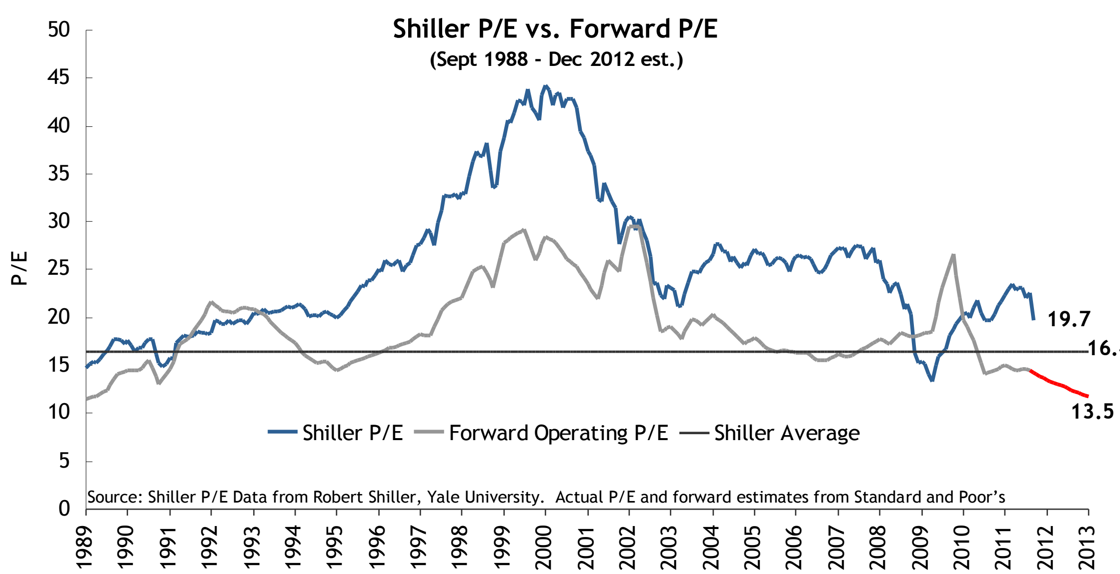
Strategy Considerations

We have had positions in iShares iBoxx Investment Grade Corporate Bond (LQD) and PIMCO Investment Grade Corporate (PBDDX) since December of 2008. While the major price appreciation through yield compression was in the past, a decent spread is still available. For high-yield bond exposure, we have done well with funds and ETFs that focus on the higher quality end (i.e., BB) of the high-yield space. Among the names we use are Wells Fargo Advantage High Income (STHYX), Lord Abbett Bond Debenture (LBNDX) and, after an adjustment to implement Research Affiliates' methodology, PowerShares Fundamental High Yield Bond (PHB).

For those concerned about rising interest rates in the future, floating rate loans also offer a decent spread and near-zero duration. After recent market declines, the S&P/LTSA 100 Index trades at $0.87 per dollar (as of August 24, 2011) and carries an interest rate geared to float with a spread over Libor. Fidelity Floating Rate High Income (FFRHX) has a seasoned manager and a strong history of adding value in the space. Investors and advisors need to ask themselves if credit risk — always present in corporate bonds — is worth the spread. Speaking broadly, we think so.

Strategy 3: Don't overpay today for tomorrow's returns

If the secular valuation decline argument made by Katsenelson is in our future, how can we still obtain some equity exposure while protecting ourselves from P/E contraction? To state the obvious, don't overpay for your investments!



We analyze stock valuations on both cyclical (three to five years) and secular (more than seven years) time frames. The chart below shows the current disconnect between cyclical and secular valuations with the 10-year cyclically adjusted P/E ratio formulated by Robert Shiller compared to forward looking earnings estimates by Standard and Poor's.

The blue normalized P/E has been in a secular downtrend for more than a decade, yet historically speaking, at 19.7 it still indicates that the market is expensive (with the historical average being 16.4). The gray line (red for future estimates) shows that the market is reasonably valued with a below average P/E if future earnings forecasts are correct.

With long-term deleveraging and slow economic growth anticipated for the foreseeable future, it's reasonable to assume that the secular decline in P/Es will continue. Owning stocks that already look cheap but still have some growth potential is a very good way to participate in the cyclical upside offered by stock investing while also protecting, on a relative basis, against the secular drag of valuation decline. Other considerations, such as balance sheet health and competitive advantage, are also important.

Strategy Considerations

Our business is asset allocation, so we don't give stock tips. We will, however, offer a few diversified funds that pursue strategies similar to those we've just outlined. Many DFA products that employ Fama-French methodology (e.g., value and core funds) and the RAFI indices are suitable places to look for low-cost indexing solutions. These value-style focused strategies help investors stay in front of the secular decline.

On the active side, we have successfully used American Century Equity Income (TWEIX) and American Washington Mutual (WSHFX) (no relation to the mortgage lender that almost imploded) successfully for years. Both funds are value oriented and have historically been heavily weighted toward the bluest of the blue-chip American companies. Both also have seasoned management teams and histories of providing low downside capture ratios during market declines.

Strategy 4: Get paid while you wait

In 1966, the S&P 500 Index hit 100. In 1978, the index was again at 100 with four more years of a secular bear market to go. In that 16-year stretch, the index suffered numerous cyclical bull and bear markets, but at the end of the period, the index value was almost exactly where it started. And this isn't even considering the damaging effects inflation had on purchasing power over this time frame. Investors made nothing, right?

Well, some investors made nothing. Some may have done just fine and earned an acceptable return given the risks they took. Those who pursued a dividend strategy and, even better, a dividend-reinvestment strategy would have done better than those who did not.

The two charts below illustrate what would have happened to two different investors in two very different market environments: the 1966-1978 stagflationary period described above and the more recent bursting of the tech bubble. The two hypothetical investors pursued the following strategies:

- Blue – received only the price return of the S&P 500
- Gray – took the price return and reinvested all dividends

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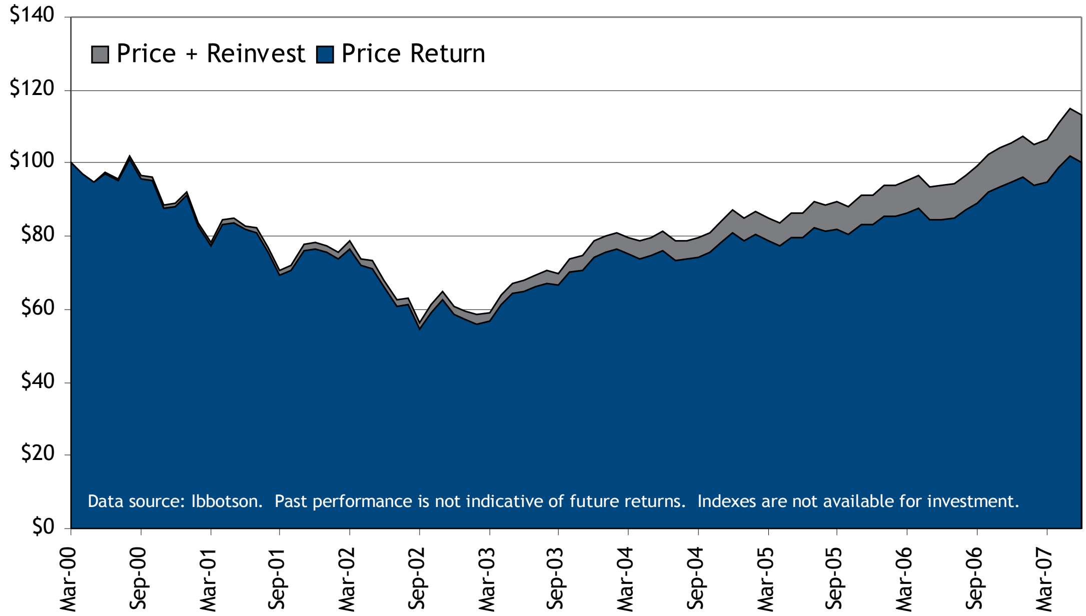
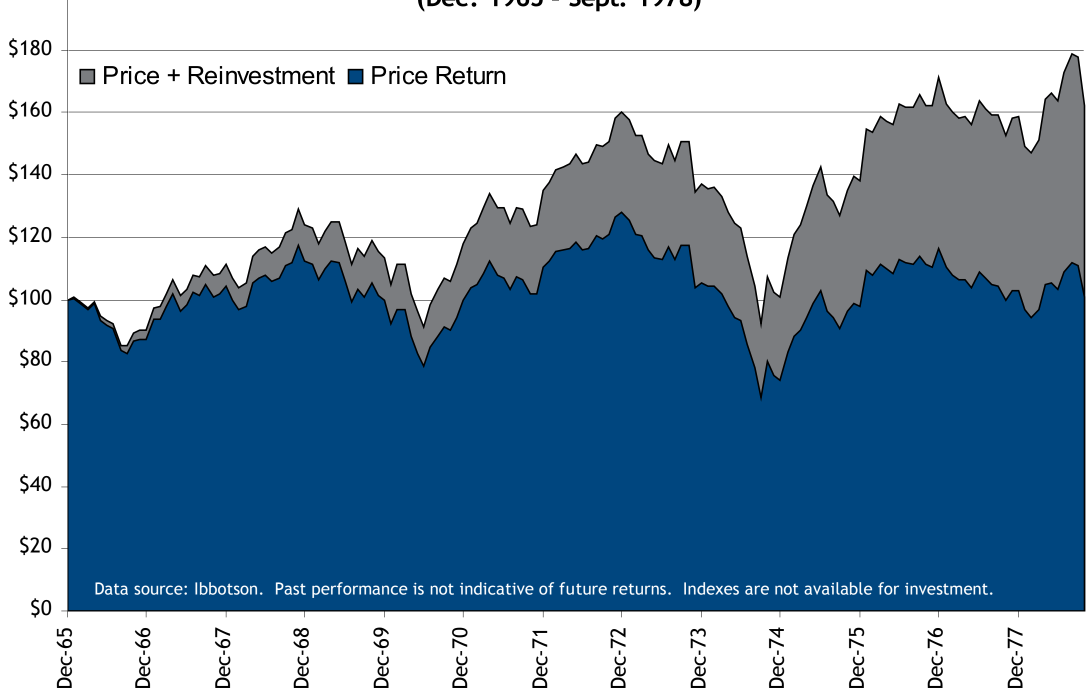
Hypothetical Portfolio - Bursting of the Tech Bubble

(March 2000 - May 2007)



Hypothetical Portfolio - 1970's Bear

(Dec. 1965 - Sept. 1978)



Dividend rates were fairly high in the 1970s, so the impact of reinvesting dividends was large.

Dividends were historically very low a decade ago, so the impact of dividends was lower but still positive.

Dividends are attractive today. The S&P 500 is currently yielding about 2%, and if the secular valuation decline discussed above continues, yields should rise further. The 2% offered by stocks is about the same as the 10-Year Treasury, which is yielding about 2.15% (as of August 29, 2011). Also, consider the following statistic from The Future for Investors by Jeremy Siegel: “From 1871 through 2003, 97% of the total after-inflation accumulation from stocks comes from reinvesting dividends. Only 3% comes from capital gains.”

Admitting up front that our analysis does not subtract for transaction costs, other fees or taxes, the benefit of pursuing a dividend strategy (especially a dividend-reinvestment strategy) is clear. It is perfectly reasonable to earn a carry through dividends while waiting for a sideways market to run its course. There are also indirect benefits to dividend strategies. For example many tend to be lower beta than the market, and as Jeremy Siegel has documented (in his book previously cited), dividend-paying stocks on average have earned better long-term returns than non-payers.

Strategy Considerations

While plenty of stocks offer attractive dividends, we caution investors to avoid the temptation to simply load up on high-dividend payers. As with Strategy 3: Don't Overpay for Tomorrow's Returns, you need a more holistic approach to selecting appropriate holdings. A high dividend that is supported by cash flows (especially free cash flows) and a healthy balance sheet is a better investment than a high-dividend that has resulted from a massive share price decline, as was the case in financials, homebuilders and REITs in 2008.

For index-oriented investors, we have used both iShares DJ Select Dividend (DVY) and SPDR S&P Dividend (SDY), both ETFs yielding over 3%. For investors looking for a more active dividend strategy, Thornburg Investment Income Builder (TIBIX) and American Capital Income Builder (CIBFX) have great histories of growing income year after year by investing in both stocks and bonds given current market opportunities. There are also numerous ways to employ a dividend theme with international and emerging markets.

Finally, we caution those who look into dividend strategies to beware of sector weights. Many dividend weighting schemes drastically overweight certain sectors, which can present a new set of risks. Know what is in your dividend strategy, and be sure to stay diversified.

Strategy 5: Own some zig to buffer the zag

We view the alternative space in two ways. There are alternative asset classes, and there are alternative investment strategies. While alternative *asset classes* such as commodities, REITs and currencies have been available to retail investors for some time, a lot of alternative *investment strategies* have come out in mutual funds and ETFs only in the last five years. This has given main street investors similar access to opportunities previously afforded only to accredited investors.

Alternative asset classes and strategies are designed for the most part to offer one major benefit: reducing portfolio volatility by zigging when more traditional asset classes zag (or at least they should zag less). In other words, they should allow you to build a more diversified portfolio, one that moves the efficient frontier line up and to the left.

Earlier, we said the likely future path of the stock market as one that is characterized by volatility and declining valuations. If that is the case, it makes a great deal of sense to add exposure to some alternatives. If alternatives do their job, allocating to them will reduce the volatility of the portfolio even if the market remains choppy.

Strategy considerations: Alternative asset classes

Concerning alternative asset classes, REITs don't look like a screaming value to us right now. Nor do commodities. At the same time, for a strategic-allocation oriented investor, there is strong historical precedent that those two asset classes will be good diversifiers, and at times, produce outsized returns.

Concerning REITs, investors need to remember that these securities must, by law, distribute 90% of their earnings to investors. Yields on REITs are currently low. That tells us that earnings power is not terribly high in the sector (or the sector has been bid up too high to make the cash flows attractive). Commodities can be a good diversifier, but that effect has come down in recent years as the risk-on-risk-off trade has prevailed, causing correlations with stocks to rise.

While opportunities can be found in single-commodity ETFs, their lack of diversification will increase, not decrease, overall portfolio volatility.

For commodities exposure, we prefer a mutual fund that recently switched its structure to a more quantitative approach. DWS Enhanced Commodity Strategy Fund (SKSRX) takes advantage of the popular Deutsche Bank Liquid Commodities Indices (DBLCI) strategies but has a more diversified approach, using the Dow Jones-UBS Commodity Index as the backdrop. To enhance return, the fund uses mean-reversion, optimal-yield placement (this is important since an inflexible trading policy coupled with a commodity in contango is a drag on returns) and a momentum strategy that can allocate a portion of the fund to cash should the market start to free fall.

Strategy considerations: Alternative strategies

Alternative strategies, which can vary widely, include market neutral, managed futures, hedged equity, global macro, event driven and merger/arbitrage. Thorough due diligence when researching these strategies is crucial – you are not simply buying an asset class. You are buying a management team who should have detailed expertise implementing a unique strategy, so you have to know the team and understand its strategy.

Expense ratios can be high with alternative strategies, but that is not always the case. There are decent managers with decent expense ratios. At the same time, there are some pretty poor performance records offered at unattractive expense ratios. Clearly, these should be avoided.

Most alternative strategies either seek alpha or information ratio (returns that are generated independent of market gyrations), or they seek to minimize downside risk. Managed futures is a classic example of a strategy that has a history of negative correlations to stocks. Broadly speaking, market-neutral strategies and hedged equity have a similar history of low correlations to stocks. While it is likely that they will serve as a portfolio drag in boom times, they should earn their keep during market turbulence.

We have had some success using hedged-equity strategies like Gateway Fund (GTEYX), which fairly mechanically offers an approximate 0.80 correlation to stocks but with only a 0.40 beta. It typically offers a decent income as well due to its buy-write overlay. A more active approach is taken by Hussman Strategic Growth (HSGFX), which can actively fully hedge or be completely unhedged based on the manager's outlook on valuation and market action. Finally, those looking to diversify among many alternative strategies might consider researching the Absolute Strategies Fund (ASFIX).

Conclusion

While the five strategies above will help guide advisors in drafting strategies for a long sideways market, they are also fairly standard portfolio building blocks. Cash, bonds, stocks and alternatives are probably already in most client portfolios. New breakthroughs in investment strategies are unnecessary. Rather, advisors should continue to plan according to their clients' needs but with an eye toward the probable future investing environment.

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