O.F.O. Partners

> "The world, you say, rests on a turtle. And that turtle on another. It is no use – it's turtles all the way down."
>
> William James

Snapping Turtles
February 2021

My friend Nicholas, who used to own an industrial manufacturing company, makes two kinds of investments: "Rockets" and "Turtles". Rockets take off, compounding Nick's money at high rates of return. The rocket fuel is ownership stakes, which are risky. There's plenty of excitement, but an occasional failed launch, too.

Turtles are slower, but sturdier. They provide regular income and stability. He keeps an eye on his Turtles, but they get along pretty well on their own.

Between Rockets and Turtles, Nicholas has done well. His average return has been about 10 percent annually since the mid-Nineties. He has watched his wealth grow. Confidence is high.

But things may get harder for Nicholas. The sand beneath the Turtles' feet has shifted.

Low interest rates have flipped the Turtle on its back. A torrent of easy money has made Rocketing growth stocks riskier than normal. Viewed together, Nicholas' time-tested mix is out of balance. We investigate the principal reasons here and offer alternative approaches in an upcoming note.

1. Low Interest Rates

For investors like you, Turtles are the slow and steady: U.S. Treasuries, municipal bonds, or corporate bonds. High-quality real estate counts, too. These markets provide you with reliable **income, stability**, and **appreciation** during recessions.

Since the Global Financial Crisis, these benefits have cracked under the hot sun of the Federal Reserve. In concert with other central banks, the Fed has compressed interest rates to encourage borrowing. Bond investing has been rewarding along the way, with reliable returns. But where to go from here? Figure 1 shows that the current 10-year U.S. Treasury yield is at 0.93 percent – *the lowest yield in history*. Bond yields have fallen *below the dividend yield of stocks*.

Figure 1. The Yield on the U.S. Treasury, 1960 - 2020

Investors seeking steady income are forced into an ugly choice: mine for yield in areas of higher risk; or forego the chance of a reasonable return. But there's more to the problem.

2. High Sensitivity.

As yields have fallen, the market for stocks and bonds has become increasingly *sensitive* to interest rate changes. In investment terms, **duration** has risen everywhere – a dangerous trend. The math is pretty clear on this one: the higher the duration, the bigger the price swings when interest rates change.

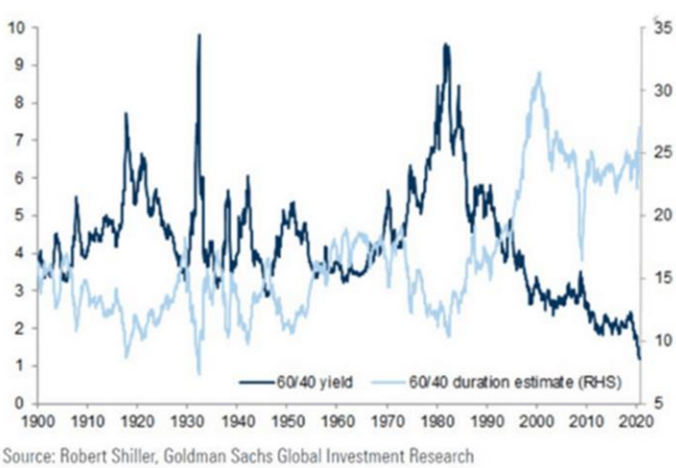

Figure 2. Duration and Yield, 1900 – 2020

Duration applies to investment patterns across the board. The values of stocks, real estate, pension liabilities, and other long-term assets are tied to the rising duration. Figure 2 shows how the sensitivity of a mixture of stocks and bonds has spiked as yields have plunged.

3. Changing Correlation

In practice, high-quality bonds are less volatile than stocks. Recently, they have also *appreciated in value during times of stress*. This inverse correlation has been a free lunch for years. People have come to depend on it. Low correlation is the bedrock assumption for allocation models used to manage trillions of dollars in assets.

Figure 3 shows how things change. From 1962 until the late-Nineties, stocks and bonds rose and fell in direct correlation – the opposite of today's bonanza. Going back to the 1880's, stocks and bonds have been positively correlated 89 percent of the time. The hedging power of Turtle-like assets to defend against declines in risky assets could be in jeopardy just when the need for protection is greatest.

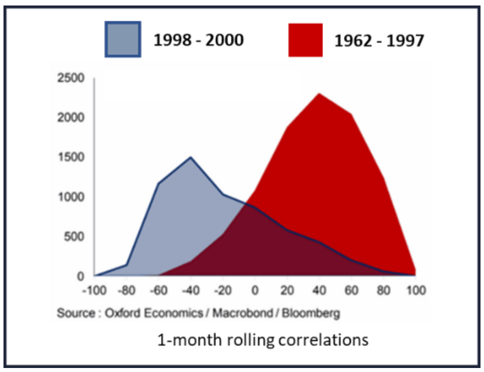

Figure 3. Frequency Distributions of Stock-Bond Correlations

The U.S. economy has faced the pandemic with resilience. Our work shows that generational assumptions for how to assemble a balanced portfolio may not be so reliable as the economy normalizes. The simple mix of Rockets and Turtles may have had its day – a victim of the economic rescue. But there is good news.

With our next publication, we will highlight investments that have been left behind unfairly in an uneven recovery. Natural resources, non-U.S. markets, and profitable small companies are just a few places to regain balance. We are not ready to retreat from delivering the slow and steady as part of a successful investment program. At OFO, we are committed to securing a safe journey for client portfolios as we navigate through 2021.

Important Information

This material is copyright 2021 by O.F.O. Partners. The information provided is for educational and informational purposes only and does not constitute investment advice. It should not be considered a solicitation to buy or an offer to sell a security. It does not reflect any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your attorney or tax advisor. All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability, or completeness of, nor liability for, decisions based on such information and it should not be relied on as such. O.F.O. Partners, LLC ("OFO Partners") is a registered investment advisor. Advisory services are only offered to clients or prospective clients where OFO Partners and its representatives are properly licensed or exempt from licensure.
For additional information, please visit our website at www.ofopartners.com. For current OFO Partners information, please visit www.adviserinfo.sec.gov by searching with OFO Partners' CRD #297424.