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Freedom portfolio performance in periods of heightened volatility

Heightened volatility such as we have seen recently – and may continue to see – is an important consideration in the Freedom portfolio construction process.

No one can anticipate a coronavirus outbreak. But risk, even when it feels like extreme volatility that shifts without warning, is part of investing. Because of that, Freedom portfolios are purposefully constructed to target the highest level of return based on the amount of downside risk you can accept in a bad market. And, currently, portfolios are positioned more defensively than normal – in an effort to enhance downside protection.

Early this year, U.S. equity markets set record highs. Yet, here we are, just a few weeks later, and volatility in the S&P 500 index is at a two-year high, as measured by the VIX index. This patch of heightened market turbulence, which is affecting all areas of the market, has been driven largely by concern for the spread of a novel coronavirus and its potential effect on the global economy. The tide seems to shift daily, with reports of lowered earnings projections from global companies countered by news of supportive central bank policy. Indeed, volatility is spiking and may remain for the near term.

Understanding that loss is uncomfortable, the Asset Management Services (AMS) Investment Committee (IC) constructs Freedom portfolios in an attempt to maximize return potential while considering the amount of downside risk a client can accept. Arguably the most important element in constructing Freedom portfolios is asset allocation – the mix of asset classes that serves to mitigate risk and minimize volatility.

KEY TAKEAWAYS

Early this year, U.S. equity markets set record highs. Just a few weeks later volatility in the S&P 500 index is at a two-year high.

Freedom portfolios are purposefully constructed to target a certain level of return based on the amount of downside risk a client can accept.

In 2017, the AMS IC started to position Freedom portfolios more defensively, shifting toward asset classes with attractive fundamentals and the potential to mitigate risk in an equity downturn.

Many factors must be considered in determining the appropriate allocation for each portfolio objective, be it Conservative or Balanced or Growth. Our goal is to attempt to maximize return for each objective's risk budget – the amount of risk the client is willing and able to accept.

While each objective has an allocation target, we do purposefully overweight or underweight individual asset classes due to our fundamental process of analyzing at the upside and downside for each investment. In 2017, the AMS IC started to shift toward asset classes with attractive fundamentals (like, for example, higher earnings-to-price ratios) and the potential to mitigate risk in an equity downturn. In fact, Freedom portfolios have their lowest beta – a measurement of risk relative to the market – since 2006.

FREEDOM POSITIONING

Currently, Freedom portfolios own a little less equity than normal and a little more high-quality fixed income, based on where the United States is in the later stages of the economic cycle. Also, money was reallocated from U.S. small- and mid-cap to more defensive large-cap positions – referred to as minimum volatility or managed volatility – as well as dividend-paying equities. The AMS IC believes this improved the quality of the U.S. equity positions in Freedom portfolios and reduced the potential for downside capture.

PORTFOLIO OVERWEIGHT POSITIONS RELATIVE TO THE AMS IC'S POLICY

Asset class	What it is	Rationale for positioning	Performance
U.S. Defensive Equity	Low volatility and dividend paying equity	Freedom began investing in low volatility two years ago when fundamentals began to look excessive. This allocation allows you to continue to own equity, yet avoid some of the downside risk.	Over the past two years, this allocation has been effective in capturing upside, with limited downside. During the most recent drawdown, the position helped add excess returns.
High-quality Bonds	Fixed income with investment-grade bonds	As valuations have moved higher and spreads in lower-quality bonds have moved lower, Freedom portfolios invested in high-quality bonds, such as U.S. Treasuries and some high-credit-quality corporate bonds.	The yield curve has flattened and inverted in some areas, pushing the price of bonds higher, providing some negative correlation benefit during the recent sell-off.
Short Duration High-quality Bonds	Fixed income with ~two-year durations, and high quality	With the flat and inverted yield curves, the upside potential for fixed income is somewhat limited and the IC felt the downside for intermediate and longer maturity bonds made them less attractive.	Short duration has provided some but limited upside during this drawdown, yet it is still a positive total return and a negative correlation position.

PORTFOLIO UNDERWEIGHT POSITIONS, RELATIVE TO THE AMS IC'S POLICY

Asset class	What it is	Rationale for positioning	Performance
Traditional U.S. Large-cap	S&P 500-style investing	Freedom portfolios' traditional U.S. Large-cap allocation is currently funding the overweight to Defensive Equity due to the relative attractiveness of the upside compared to the downside potential of Large-cap.	Defensive equities have outperformed traditional equities during this last year and the last two sell-offs.
U.S. Small- & Mid-cap Equities	Smaller market cap U.S. companies	U.S. Small- and Mid-cap valuations appeared extremely unattractive two years ago when the IC reduced the exposure within Freedom. This is because Small-caps typically capture a larger percentage of negative markets.	Since Freedom reduced Small- and Mid-cap equity, those asset classes have underperformed the broad markets.
High Yield Fixed Income	Lower quality bonds with equity-like characteristics	Freedom portfolios started reducing their allocations to high-yield bonds two years ago when spreads between cost and return became undesirable. Traditional allocation to this asset class funded the investment in investment-grade fixed income.	High-yield bonds have performed well during the up markets, but have fallen along with equities in down markets.

LOOKING AHEAD

Analysts are adjusting equity price-to-earnings valuations based on revised earnings and sales projections. The U.S. Federal Reserve cut its short-term lending rate by 0.50% to reach a target range of 1.00% to 1.25%, and other central banks have pledged support in response to the coronavirus. Overall, forecasts call for growth, though slower growth than in recent years with the record-long expansion in its second decade.

The AMS IC evaluates Freedom portfolios on a continuous basis, and will continue to monitor these factors and more. Keep in mind, most changes to Freedom portfolios over the past two years were in anticipation of increased volatility and downside potential. Any additional changes would occur in an attempt to earn the best possible return for the amount of downside risk the committee is willing to tolerate, in alignment with portfolio objectives and client goals.

If you have any questions, particularly if your goals have changed, please contact your advisor.

DISCLOSURES

The contents of this white paper reflect the thoughts and opinions of Raymond James Asset Management Services and are subject to change without notice. These materials are for information purposes only and should not be construed as a recommendation regarding any security outside of a managed account. This report does not purport to be a complete description of the securities, markets or developments discussed.

It is important to review the investment objectives, risk tolerance, tax objectives and liquidity needs before choosing an investment style or manager. All investments carry a certain degree of risk and no one particular investment style or manager is suitable for all types of investors; you may incur a profit or a loss. Past performance is no guarantee of future results. There is no assurance that any investment strategy will be successful.

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Indices and peer groups are not available for direct investment. Asset allocation and diversification do not ensure a profit or protect against a loss. Strategies discussed are subject to change at any time by Asset Management Services due to market conditions or opportunities.

- Fixed-income securities (or “bonds”) are exposed to various risks including but not limited to credit (risk of default or principal and interest payments), market and liquidity, interest rate, reinvestment, legislative (changes to the tax code), and call risks.
- There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices generally rise. Short-term bonds with maturities of three years or less will generally have lower yields than long term bonds which are more susceptible to interest rate risk.
- Please note these portfolios may be subject to state, local, and/or alternative minimum taxes. You should discuss any tax or legal matters with the appropriate professional.
- International investing involves special risks, including currency fluctuations, different financial accounting standards, and possible political and economic instability.
- Investing in emerging markets can be riskier than investing in well-established foreign markets. Emerging and developing markets may be less liquid and more volatile because they tend to reflect economic structures that are generally less diverse and mature and political systems that may be less stable than those in more developed countries.
- Investing in small-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor.
- Stocks of smaller or newer or mid-sized companies may be more likely to realize more substantial growth as well as suffer more significant losses than larger or more established issuers.
- These portfolios may be subject to international, small-cap and sector-focus exposures as well. Accounts may have over weighted sector and issuer positions, and may result in greater volatility and risk.
- Companies in the technology industry are subject to fierce competition, and their products and services may be subject to rapid obsolescence

DEFINITIONS

Small-cap: Small cap is a term used to classify companies with relatively small market capitalization (value). A company's market capitalization is the market value of its outstanding shares. The definition of small cap can vary among brokerages, but it is generally a company with a market capitalization of between US$300 million and $2 billion.

Mid-cap: Mid-cap is the term given to companies with a market capitalization (value) between $2 and $10 billion. As the name implies, a mid-cap company falls in the middle of the pack between large-cap and small-cap companies. Classifications such as large-cap, mid-cap and small-cap can change over time.

Large-cap: Large-cap refers to a company with a market capitalization value of more than $10 billion. Large-cap is a shortened version of the term "large market capitalization." Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Price-to-Earnings Ratio: The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings (EPS). The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple. P/E ratios are used by investors and analysts to determine the relative value of a company's shares in an apples-to-apples comparison. It can also be used to compare a company against its own historical record or to compare aggregate markets against one another or over time.

CBOE Volatility Index (VIX): Created by the Chicago Board Options Exchange (CBOE), the Volatility Index, or VIX, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 index options, it provides a measure of market risk and investors' sentiments. It is also known by other names like "Fear Gauge" or "Fear Index." Investors, research analysts and portfolio managers look to VIX values as a way to measure market risk, fear and stress before they take investment decisions.

S&P500: The S&P 500 Index (formerly Standard & Poor's 500 Index) is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value. The index is widely regarded as the best single gauge of large-cap U.S. equities.

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