WE REDUCED PORTFOLIO RISK AS INVESTORS WAIT FOR BETTER TIMES

By Don McArthur, CFA®

Commerce Trust Company Senior Investment Strategist and Director of Equity Research Don McArthur, CFA®, manages the Fundamental S&P 500 Equity Strategy at Commerce Trust Company. Mr. McArthur is a regular contributor to many articles in the financial press and is a featured speaker at Commerce Trust client investment summits throughout the year in the Midwest. Equities certainly bore the brunt of the recent market downturn, as the decline of 19.6% in the S&P 500 was the worst first quarter in history and March was the most volatile month ever. Mr. McArthur shares his point of view on the equity market as we head into new territory in the second quarter.

AS HEAD OF COMMERCE TRUST COMPANY'S EQUITY ANALYST TEAM, WHAT ARE YOU MOST FOCUSED ON IN THIS VOLATILE ENVIRONMENT?

Over the past several weeks we've been actively reducing our clients' exposure to riskier areas in the markets and re-deploying those funds into cash or higher quality areas. It is important to remember, however, that equity strategies vary for every client depending on their particular financial goals.

IN WHAT AREAS HAVE YOU REDUCED RISK IN A TYPICAL PORTFOLIO?

Generally speaking, one example is that we've reduced our positions in high-yield bonds, which are riskier bonds with lower credit quality. We have also reduced positions in small-capitalization International stocks as well as small-cap domestic stocks. The reason is small caps generally have higher debt levels resulting in more challenged balance sheets. This makes them riskier, as in slower economic growth environments – revenue, profits, and cash flow decline and their ability to pay back that debt becomes more of an issue.

WHAT DO YOU TYPICALLY DO WITH THE PROCEEDS AFTER YOU HAVE REDUCED THESE POSITIONS?

For this portion of risk-reduction we are holding the proceeds from the sales in cash. This provides two things that investors value. The first is peace of mind for clients who are concerned about the impact of coronavirus developments on their portfolios and dealing with uncertainty. Additionally, it provides cash to invest into the market at what could be more attractive levels in the future, but at least when we see more visibility into how this situation may unfold.

YOU MANAGE SOME OF THE COMMERCE TRUST'S EQUITY STRATEGIES THAT MAY BE PART OF A CLIENT'S PORTFOLIO, WHAT ARE YOU DOING IN THOSE STRATEGIES?

Again, in general, we sold or reduced stocks in certain areas that we viewed as riskier depending upon a clients' particular situation. They include Energy, which is facing both supply increases from Russia and Saudi Arabia with some breakdown in OPEC+ agreements. At the same time, isolation around the world is causing massive demand disruption around the globe.

While we didn't foresee this type of economic slowdown when we began selling Energy stocks weeks ago, the combination of increased supply and decreased demand has the world producing over 20 million barrels of oil more than we need every day. For reference, before COVID-19 the world used around 100 million. There is an issue with where to put an extra 20-plus million barrels of oil each and every day.

Also, where appropriate, we also sold some more cyclical stocks, or those that are dependent on the growth of the economy for their businesses to thrive. Additionally, we sold companies with higher debt levels that could be problematic in the severe economic downturn coming in the second quarter.

IN THOSE STRATEGIES, WHAT DID YOU DO WITH THE PROCEEDS FROM THE SALES?

Again, every investor's portfolio is unique, and it is best to consult with a seasoned advisor for your particular situation. In addition to increased cash balances, we invested a portion of the proceeds from the sales into companies that we viewed as higher quality. Those companies would include firms where there are recurring revenue streams that should hold up relatively well in an economic slowdown. Companies with strong balance sheets and relatively lower levels of debt and/or visible cash flow. We also added to positions in stocks we already owned that, due to the decline in the stock market, looked even more attractive. When the market has strong moves to the downside like we saw several times in March, we see indiscriminate selling – meaning everything goes down as investors panic. We took that opportunity to purchase good companies at a lower price.

So, in general, we are currently lowering risk and increasing quality, but preparing to be ready for better times.

WHEN WE ULTIMATELY REACH A MARKET BOTTOM, WHAT FACTORS OR TACTICS MIGHT BE CONSIDERED IN EVALUATING A SHIFT IN INVESTMENT STRATEGY?

As the market works through a crisis and begins to look ahead to better times, historically we see a change in portfolio allocations from higher quality, lower risk areas to higher growth areas which carry greater risk. Typically, we see a combination of quality areas of the market working initially as investors want to gain exposure with less risk. Then we see factors shift toward areas with more risk and upside if the economy rebounds. This would favor stocks over bonds.

Again, within stocks we would see the market rotate toward riskier areas. This would include smaller capitalization stocks that usually went down more going into "the bottom" rather than larger issues that held up well going into it. After an ultimate bottom we would expect stocks with higher betas to do better. Beta is a measure of how much a stock moves in relation to the move of a stock index like the S&P 500. A higher beta means the stock should move more than the market in the same direction. So, in a rising market a higher beta stock would do better. Another area that would do well would be lower quality areas that saw their earnings go down more than the average, but have more upside in an improving environment or those that had their balance sheets stressed and it looks like with an improving environment they are going to make it out ok.

In the end, after an ultimate bottom, returns depend on the trajectory of the rebound and what has been priced into various markets. We'll obviously be keeping a close eye on all economic indicators in order to continue to make adjustments for our client's portfolios.

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