



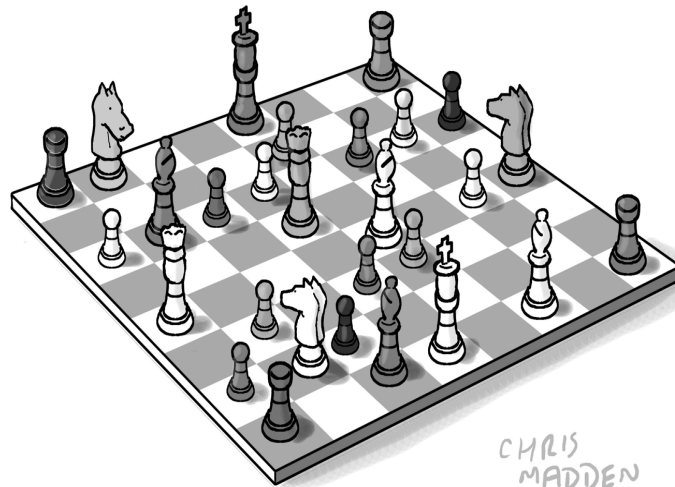
PACIFICUS
CAPITAL MANAGEMENT

INVESTMENT OUTLOOK – MARCH 2023

Managing Risk for Ordinary Investors

“History is written by the winners.” — Napoleon Bonaparte

CONFLICT IS HARDER TO SUSTAIN WHEN YOU
DON'T SEE EVERYTHING IN BLACK AND WHITE



CartoonStock.com

Market anxiety is high while confidence is low. The recent failure of both Silicon Valley Bank and Signature Bank has investors on edge, and for some is reminiscent of the 2007-09 global financial crisis. Although, I do believe the current bank failures are very serious and are likely to reverberate throughout the financial system on down to the real economy, I also believe the severity of the problem is less far reaching than the previous episode.

Nevertheless, intraday market volatility is out of control and is a symptom of a sick patient. In times like these, the best thing an investor can do is step back, decrease risk and wait for the dust to settle.

Benjamin Graham, the father of value investing and mentor to Warren Buffet argued the stock market suffers from bipolar disorder, frequently swinging between mania and depression.

Considering the large psychological element to both individual investors and the market as a whole, it would be wise for many of us to take in a deep breath, exhale, and separate fact from feelings.

Bank failures are deflationary. Credit contracts, the velocity of money declines, and economic activity decelerates. Couple this with a previously slowing economy and the magnitude of our soon to be realized recession likely becomes more severe than originally expected.

This doesn't mean investors should be out of the market. In practice it is virtually impossible to time an "all-in" or "all-out" strategy, as I've yet to see this form of speculation yield positive repeatable results. Instead, investors should target volatility reduction, attempting to overweight market sectors with high expected returns and underweight those with lower expected returns. Like many other aspects of life, managing portfolio risk is about balance.

A few years ago, I wrote the below newsletter on managing risk and the relationship between long-term returns and portfolio variability. Today is as good a time as any, to highlight what competent professional investment management brings to the table for ordinary investors in an uncertain world.

Go for It! Swing for the fences! No guts, no glory! These popular phrases are often blurted out when something risky is on the line. Whether you are a professional athlete looking for a win, an entrepreneur starting-up a business, or a newly engaged couple committing to a relationship, much of what we encounter throughout our lives deals with taking either direct or indirect risks.

As an investor, risk taking is unavoidable. The question many of us must come to terms with is - how much risk am I truly comfortable with? Do I swing for the fences and go for broke, or do I stash my money away in a savings account and rest easy at night? When times are good, investors tend to overestimate their willingness to take-on risk, and when times are rough the opposite is often the case. To invest successfully, knowing oneself can be far more important than financial acumen.

Many experienced investors are aware of the importance of avoiding large losses and the negative effect this has on compounding returns. As a simple example, using a theoretical investment of \$1,000,000, we can observe how much must be gained after a loss, in order to make it back to breakeven. A -10% loss turns the original investment

into \$900,00 and requires a +11.1% return to get back to \$1,000,000. A -30% loss turns the original investment into \$700,000 and requires a +42.9% return to get back to \$1,000,000. While a -50% loss turns the original investment into \$500,000 and requires a +100% return to get back to \$1,000,000. Simply put, the larger the loss, the more difficult it is to work your way back to even.

The illustration above may be intuitive for many readers, however equally if not more important is a related concept, which focuses on the impact of portfolio volatility and its effect on long-term investment performance. Too often, investors, and sadly some investment managers are solely focused on producing big returns at the expense of tolerating high levels of volatility. This is a mistake.

Variance drain, also known as volatility drag, are the terms used to describe how different levels of portfolio volatility result in markedly different returns over time. Variance drain operates under the theory that comparing two portfolios with the same beginning and same average returns, the portfolio with the greater volatility will have a lower compound return, and therefore less ending wealth. Not only does controlling portfolio volatility make investors feel more comfortable, which enables them to stay the course, but minimizing volatility actually grows wealth faster than more volatile portfolios which exhibit the same or even higher returns.

Marc Odo, of Swan Global Investments, did a good job describing this concept in a blog post, "Volatility is a Drag" dated September 29, 2016. He starts with the illustration below asking which of the following three scenarios would yield the best 10 year results:

1. A portfolio up 10% one year, then down 5% the next year, with this pattern repeated for 10 years.
2. A portfolio up 25% one year, then down 20% the next year, with this pattern repeated for 10 years.
3. A portfolio up 40% one year, then down 35% the next year, with this pattern repeated for 10 years.

And the winner is... Portfolio number 1. Despite its modest gains and losses, Portfolio 1 performs the best and is the only profitable scenario. Portfolio number 2 breaks even, while Portfolio 3 loses money.

Variance drain was first introduced in The Journal of Portfolio Management by Thomas E Messmore in the 1995 summer edition. Messmore concluded that the more volatile an asset's return, the greater the difference between its arithmetic and geometric returns. For readers who would like a better understanding of the math behind the above

outcomes, please see the links provided here for definitions of [arithmetic](#) versus [geometric](#) returns.

To get a sense of how important controlling volatility in an investment portfolio can be, I reproduced the below eye-opening table on variance drain, which was originally published in the book “The Stewardship of Wealth: Successful Private Wealth Management for Investors and Their Advisors” by Gregory Curtis. Readers will find six scenarios, with different levels of volatility as measured by standard deviation, all corresponding to a 10-year time horizon. Notice as a portfolios Standard Deviation increases the Ending Funds and Total 10 Year Period Return % decreases.

10-Year Returns Based on Different Portfolio Volatilities

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
Arithmetic Annual Return	10%	10%	10%	10%	10%	10%
Standard Deviation	0%	10%	20%	30%	40%	50%
Geometric Annual Return	10%	9.6%	8.3%	6.03%	2.58%	-2.42%
Starting Funds	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Ending Funds	\$2,593,742	\$2,501,561	\$2,219,353	\$1,796,293	\$1,290,725	\$782,784
Total 10 Year Period Return	159%	150%	122%	80%	29%	-22%

Source: Greycourt

Batten down the hatches and dust off the risk-off playbook. Investors will need to shift focus for the time being from a mindset of a return *on* capital to a return *of* capital. In this scenario, Treasury bills, notes, and bonds are the place to be, followed by gold and high quality-low beta equities. With that said, many of the large cap tech names are of high quality, interest rate sensitive, and were absolutely pummeled last year. No wonder they are outperforming or even posting positive returns year to date.

Our portfolios are generally overweight money markets, US Treasuries and precious metals. On the equity side, we are underweight international exposure, financials and energy, while overweight large cap tech, a select few REITs, home builders and generally interest rate sensitive sectors, sprinkled-in with some low-beta plays such as consumer staples and healthcare.

ASSET CLASS & SECTOR OPINIONS		
OVERWEIGHT	NEUTRAL	UNDERWEIGHT
Cash & Money Markets	Mortgage-Backed Securities	Leverage Loans (Floating Rate Debt)
U.S. Treasury Notes & Bonds	Local Currency EMG Bonds	Treasury Inflation Protection Securities
Large Capitalization Technology	Investment Grade Corporate Bonds	High Yield Corporate Bonds
U.S. Real Estate & Related Equities	Consumer Discretionary Sector	Small Capitalization Stocks
Aerospace & Defense	Communication Services Sector	Financial Services Sector
Consumer Staples	Utilities	Materials Sector
Precious Metals	Healthcare	Energy Related Equities
	Leisure & Hospitality	International Developed Market Equities
		Emerging Markets Equities

Sincerely,
Justin Kobe, CFA
Founder, Portfolio Manager & Adviser
Pacificus Capital Management



Advisory services through Cambridge Investment Research Advisors, Inc., a Registered Investment Adviser. Securities offered through Registered Representatives of Cambridge Investment Research, Inc., a broker-dealer, member FINRA/SIPC. Cambridge and Pacificus Capital Management are not affiliated.

Material discussed is meant for general illustration and/or informational purposes only, and it is not to be construed as investment, tax, or legal advice. Although the information has been gathered from sources believed to be reliable, please note that individual situations can vary. Therefore, the information should be relied upon when coordinated with individual professional advice. These are the opinions of Justin Kobe and not necessarily those of Cambridge Investment Research, are for informational purposes only, and should not be construed or acted upon as individualized investment advice. Investing in the bond market is subject to risks, including market, interest rate, issuer credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies is impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Diversification and asset allocation strategies do not assure profit or protect against loss.