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Food for Thought: "Reducing the Risk of Black Swans"

EXECUTIVE SUMMARY

Black Swans are monumental events, either great or horrible, which seem impossible but have enormous consequences. In their new book, *Reducing the Risk of Black Swans: Using the Science of Investing to Capture Returns with Less Volatility*, Larry Swedroe and Kevin Grogan show us how they believe we can potentially avoid the dreaded Black Swan and increase the odds that we will achieve the investment returns that we are seeking. They build on the basic principles of evidence-based investing and explore the alternative markets by introducing alternative investment sources that have previously been less available to individual investors. This white paper summarizes evidence-based investing concepts and describes four alternative sources of expected returns that are detailed in the book by Larry Swedroe and Kevin Grogan.

If there's one thing you can count on in both life and investing, it's uncertainty. It's why we save and invest to begin with. We save and invest today, hoping our money will grow. We act on our aspirations for a bright financial future. ***But we never know for sure.***

It stands to reason, then, if there were a credible, evidence-based way to reduce uncertainty and enhance expected returns … you'd be all over it, right?

According to *Reducing the Risk of Black Swans*, co-authored by Larry Swedroe and Kevin Grogan, there *is* a credible way to increase the odds of achieving your financial goals. The subtitle says it all: ***"Using the science of investing to capture returns with less volatility."*** In the authors' words, this book "is a roadmap to the holy grail of investing—an investment strategy that can deliver higher returns without increased risk, or the same return with reduced risk."

That's a big claim. How do the authors suggest we achieve it? To find out, you'll want to read this book for yourself. But here's a handy overview to get you started.

Building on the Basics

What do we already know about the science of investing? It begins with these principles:

- **Asset Allocation:** To increase expected returns while managing related risks, build a low-cost, globally diversified portfolio with assets allocated to various dimensions of expected returns. The allocations should reflect your personal goals and risk tolerances.
- **Low Correlation:** Diversify your investments across different sources of returns to seek a smoother "ride" and more consistent results. For this, you want to combine sources that have exhibited low correlation with one another (as the authors explain in Chapter 2).
- **Efficient Implementation:** Use fund providers who manage their solutions in a low-cost and tax-efficient manner.
- **Stay the Course:** Work with an advisor to help you manage your portfolio and stay the course — especially when market volatility is challenging your resolve, as it will regularly do.

Taken as a whole, this is **evidence-based investing**. If it sounds familiar— better yet, if it's how you're already investing — you're on the right track.

But, what if you could improve on these basics without sacrificing any of the essential principles of a sound, evidence-based investment approach?

Just as the telephone begat the cell phone, which led to the mobile device, innovation often offers efficiencies we couldn't even imagine until they were within reach. In portfolio management, newer (but well-vetted) tools and technologies have combined with new insights from the academic community to capture additional — ***alternative*** — sources of expected return.

Evidence-Based Investing in Alternative Markets

Alternative sources of return have long existed and have been used by institutional investors such as major endowments and hedge funds. But until recently, many of them were either unavailable to retail investors or their excessive fees rendered them impractical and cost prohibitive. Swedroe and Grogan describe how these challenges are currently being met, and in some instances, overcome. The results? ***Practical new***

ways to consider incorporating additional sources of expected returns — using the same, time-tested evidence-based tenets we already employ.

In Part I, the authors introduce "The Larry Portfolio." With it, we can tinker with the traditional 60/40 stock/bond mix, to increase the odds that you'll earn the returns you're seeking. This feat is achieved by concentrating your equity holdings in riskier factors (such as U.S., international and emerging market small-cap value stocks), while offsetting those risks with a bigger allocation to high-quality bonds. You can hold less equity risk because the equities you do hold have higher expected returns.

In Part II, the authors introduce four alternative sources of expected returns beyond stocks:

1. **Alternative lending**: These are consumer, small business and student loans made outside of the traditional banking system.
2. **Reinsurance**: Insurance companies sometimes insure *themselves* (reinsure) against big claims.
3. **Variance risk premium**: Buyers insure stocks, bonds, commodities and currencies with puts and calls. Put and call sellers earn an expected premium for providing that insurance, just as insurance companies earn an expected return for protecting against various losses.
4. **Style premia**: Beyond more familiar stock and bond market premia, there may be other sources of expected returns to capture in stocks, bonds, commodities and currencies.

Each of these alternative investments are expected to deliver returns comparable to stocks… but they've also exhibited enticingly low correlation to stock and bond market performance, as well as to each other.

Let that sink in for a moment, because it's the essence of this book's premise.

Put simply, adding alternatives in an evidence-based manner is a continued tale of the power of diversification, including the potential to create a whole portfolio that is stronger than the sum of its parts. The authors show you their supporting evidence, and conclude (emphasis ours): "Because each of the alternatives we have discussed shows low correlations to other portfolio assets, we should end up with a more efficient portfolio — one with similar returns but less risk."

The Future Is Here … and It's a Challenging One for Investors

You may still be wondering: Even if you ***can*** now include alternative investments in your evidence-based investment portfolio, ***should*** you? For many investors, it may be worth considering. Not to alarm you, but it's important to know that the overall future expected premium for the stock market is lower than its long-term average.

In the book's foreword, Ross Stevens of Stone Ridge explains the dynamics of future expected returns, as do Swedroe and Grogan in Chapter 1. Bottom line, when current stock market valuations are historically high, forecasts for real future returns are low. The authors conclude that on an average annual basis, "most financial economists [are] forecasting real future returns in the range of about 4 to 5 percent."

An expected real return of 4–5 percent isn't much compared with past real returns closer to 7 percent.

The authors also emphasize that nobody knows what will ***actually*** happen. In particular, a Black Swan could send stock markets into a tailspin.

So, What Is a Black Swan?

For an exhaustive exploration, we refer you to the work of Nassim Nicholas Taleb, who coined the term. In his book, *The Black Swan*, he defines it as an event that (1) seems almost impossible, until it happens, (2) has monumental consequences, and (3) somehow seems explainable, but only after the fact… 20/20 hindsight!

A Black Swan can be wonderful, like winning the lottery, or horrible, like having your house burn to the ground. In financial markets, the Great Recession is a relatively recent Black Swan. If you experienced it, you know how bad it was. Even if you were able to remain disciplined and participate in the recovery that followed, you likely yearned for some other way to earn decent returns without having to tolerate such deep, dark dives along the way.

That's exactly what *Reducing the Risk of Black Swans* is about. It explores how to clip the wings of the dreaded Black Swan with evidence-based strategies for sustaining your portfolio's expected returns while simultaneously trimming down its "fat tails" of potential risks—especially the worst ones.

You and Allodium Investment Consultants

We encourage you to read this little book for yourself. That said, it takes a relatively deep dive into portfolio construction theory. As questions or comments arise, please be in touch with us for clarification, especially if this is your first glimpse at evidence-based investing. Whether it's helping you achieve your greatest goals, defend against the darkest Black Swan, or simply charting a confident course through life's uncertainties, we're here to serve as your guide.

About Allodium Investment Consultants

Allodium Investment Consultants is a fee-only investment management consulting firm that provides investment management services to both individual and institutional investors. Advisory services include Wealth Management, Fiduciary Management, Investment Management Consulting, Financial Planning and Fiduciary Consulting. The firm is a member of the National Association of Personal Financial Advisors (NAPFA) and provides fee-only financial advice that supports the fiduciary standard of care. Allodium is certified by CEFEX to follow the fiduciary best practices in the *Prudent Practices for Investment Advisors* and was the first Minneapolis-based investment advisor to receive this certification. The firm was established as an Independent Registered Investment Advisor in 2005. Learn more at www.allodium.com.

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