How's My Portfolio Doing?

Risk, Return, and Long-term Investing

CRAWFORD
INVESTMENT COUNSEL
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Investment returns are front of mind for market participants. Results are frequently tracked and measured on both an absolute and relative basis, but these measures typically ignore risk. To begin, absolute return assessment is ultimately the most important measure of the success of an investment program. This is particularly important if clients have spending needs, specific return requirements, or actuarial assumptions they are seeking to meet. Conversely, relative return comparisons provide perspective as to how an investment program has performed relative to other opportunities in the capital markets. Relative return comparisons are measured versus a market index or portfolio benchmark, focusing more on portfolio return and alpha as a measure of risk-adjusted return compared to a market average or peer group. At Crawford Investment Counsel (Crawford), we seek to produce attractive results with low risk. We strive to provide our clients with sound outcomes when examined both in an absolute manner and over the longer term when compared to the appropriate market averages or blended indices.

One of the more important aspects of Crawford's strategies is the fact that they all have an above-average income component. This, combined with a higher-quality and value-oriented approach, leads to results with lower volatility over time. We believe that not only are Crawford's return patterns less risky and more predictable, but a significant advantage of our approach is the high likelihood of a lower drawdown (decline) when markets are weak. In our estimation, this is important for all investors, but it is particularly critical for our clients who are living off their portfolios, have expected liquidity needs, or are contemplating expenditures in the not-too-distant future. The impact of declining portfolio values coupled with withdrawals (spending) can be detrimental to the long-term benefits of compounding values. We must note that most typically, periods of economic stress are accompanied by market declines. It is in these periods when an unexpected or unanticipated demand on a portfolio can be especially destructive to long-term portfolio value, undermining the power of compounding. We must also note that it is in these periods where above-average relative returns are a small consolation and the importance of absolute returns and preservation of capital increases significantly.

If it were as simple as focusing on relative returns when the market is strong and absolute returns when the market is in decline, everyone would do it. However, predicting the market, especially on a shorter-term basis is both risky and uncertain. With this being said, and out of consideration for the long-term benefits of stock ownership, Crawford is a proponent of staying invested through full market cycles. Nevertheless, we only do so while striving to maintain our high-quality bias, which is defensive in nature. We own dividend-paying companies that are value-oriented in nature, or in other words, are priced favorably relative to their underlying business metrics. This approach enables participation in up markets and most typically, protection when the market declines. This "smooths out the ride" for our investors and serves as an efficient means of managing risk while satisfying other portfolio objectives. A few of these objectives include a healthy level of stock ownership and satisfactory risk-adjusted returns on both a relative and absolute basis.

Risk-adjusted return measurement can be a cumbersome exercise, and there are various conventions to help calculate "return per unit of risk." This process is not a simple one, and it is a component of the Capital Asset Pricing Model (CAPM), which is derived from Markowitz's Modern Portfolio Theory (MPT). The CAPM equation uses beta as a proxy for risk, and it assumes markets are efficient. In our estimation, this assumption on market efficiency is not a valid one. In fact, we believe the market is frequently inefficient in assessing risk. This does not make risk management any less important, however. Actually, it gives us confidence that we can earn above-average, risk-adjusted outcomes. There are empirical studies that back this up, refuting key components of both the CAPM and MPT by identifying lower risk (beta) portfolios as leading to higher return outcomes on an absolute basis (not relative to risk). These studies are a historical representation of what Crawford's clients have experienced for over 40 years where lower risk, higher-quality portfolios can and will lead to very satisfactory results on both an absolute and relative basis.

One of the challenges we face as investors is maintaining a lower risk profile when everything looks good and the market is advancing. We liken this to an insurance premium that is paid but never collected upon until disaster strikes. Owning a lower-risk portfolio after a period of strong market results can tempt one to abandon a safer program in the interest of "keeping up with the market." This herd-like behavior can drive market averages higher as human nature leads participants to chase returns and adopt more risk as the market cycle matures. This is the exact opposite of what prudent risk management would suggest one should do. In other words, when market returns are robust, investors tend to be more focused on relative results, forgetting that the return of capital is often more critical than the return on capital. This behavior pattern can lead investors on a path to changing or abandoning an investment program, or disillusionment within the stock market. It is frequently highly detrimental to the positive benefits of compounding investment returns.

One other important component of risk management is working with a professional investment advisor that can help articulate the benefits of staying invested. We believe the best way to disrupt the positive effects of compounding is to change strategy or even worse, abandon stocks altogether. At Crawford, we have an investment philosophy that is grounded in both classic investment theory and common sense, and we are consistent in communicating and reinforcing this with our clients. Crawford's approach seeks to provide our clients with continuity, help remove emotions from investing, and rely on time-tested principles that work.

Crawford Investment Counsel's competitive relative and absolute returns coupled with risk management and a service model honed for over 40 years all work together, leading to successful outcomes for our clients. Investors are certainly forced to make tradeoffs, but we believe owning a competitively returning, lower-volatility portfolio which provides downside protection and perhaps most importantly, staying with that investment program over the longer term, are key components of successful investing. There are many effective ways to invest, but Crawford's methodology is a user-friendly and highly effective means of growing wealth over time.