Key Private Bank

Key Questions

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# Can Nothing Be Something Great?

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Doing nothing doesn't seem like good investing advice. But sometimes, standing pat is the best game plan for an actively managed portfolio.

Described as "a show about nothing," ***Seinfeld*** was a sitcom that aired on NBC from 1989 to 1998. While the comedy was technically about a group of friends and the minutiae and nuisances experienced in daily life, no particular theme or lesson was to be learned.

In season four, the actual creation of the show is parodied when NBC asks Jerry Seinfeld to create a sitcom. In the episode "The Pitch," Jerry and his friend George Costanza (a character based on Larry David, who helped create *Seinfeld*) discuss a possible premise after noticing that salsa and seltzer sound similar, which could create confusion.

George: "See, this should be the show. This is the show."
Jerry: "What?"
George: "This. Just talking."
Jerry: (dismissively): "Yeah, right."
George: "I'm really serious. I think that's a good idea."
Jerry: "Just talking? Well, what's the show about?"
George: "It's about nothing."

As it turned out, George was on to something: *Seinfeld* was the top-rated show in six of its nine seasons. And just as a show about nothing was a success, sometimes doing nothing with your investment portfolio might be the best advice you can get.

Key Private Bank Managing Director of Equity and Fixed Income Research Steve Hoedt notes that the markets are currently experiencing the summer doldrums, a common occurrence at this time every year. However, after what seems like a few decades of events compressed into the last 18 months and a protracted period of extreme volatility, a decline in turbulence is refreshing: It can provide an opportunity to refocus on the core tenets of long-term investing, such as the benefits of asset allocation, rebalancing, and the fact that actively doing nothing is doing something.

At times, the financial media can become hyper-consumed with the market topic ***du jour*** (meme stocks, hedge fund blow-ups, soaring lumber prices, etc.) as these appear entertaining, especially compared to discussions about long-term asset allocation and rebalancing. However, paying attention to mundane topics has proven to be much more beneficial to investors' wealth over the long term. As the time horizon expands, the probability of rising equity prices increases, suggesting that in many instances doing nothing in terms of actively buying and selling (aside from disciplined rebalancing) is doing something — and that something can turn out to be great.

Asset allocation, or determining the right composition and proportion of different asset classes (stocks, bonds, cash, non-traditional investments, and real assets), is likely the essential decision investors need to make. Numerous studies have indicated that asset allocation accounts for 80% to 90% of an investor's long-term returns and risk (as measured by volatility).

The "right" mix is investor-specific and based on key factors such as time horizon, cash needs, and tolerance for losses. Ultimately, the best asset allocation is the one an investor can stick with for a long time. In addition, calibrating tolerance for losses is vital given the wide range of market events that can be experienced over time.

From 2001 to the present, the worst loss for a portfolio composed of 20% stocks (US and international equities) and 80% bonds has been -13.6%, while the worst loss for an 80% stock and 20% bond portfolio is -49%. Behavioral studies have shown that the emotional impact of losses is at least 2x that of gains. However, with greater risk tolerance, higher gains can be achieved.

The 20% stock portfolio gained 5.4% per annum, while the 80% stock portfolio gained 7.5%. This may not seem to be much of a difference, but with the magic of compounding, the ending portfolio value of the 80% stock portfolio is 47% higher than that of the 20% stock portfolio.

Disciplined rebalancing can enhance the risk-adjusted returns and keep current portfolio allocations in line with the investor's long-term asset allocation target. A typical methodology is to create bands around asset weights and then rebalance the portfolio if the bands are breached.

For example, for an investor targeting 60% stocks and 40% bonds, rebalancing could be triggered when the stock allocation increases or decreases by 5%. What does this lead to over time? Ultimately, the investor will be buying stocks after a period of price declines and selling stocks after a period of price increases -– or adding to equities at lower prices and decreasing exposure to equities at higher prices. With the propensity of stocks to outperform bonds, never rebalancing would lead to a breach in risk tolerances for many investors. For taxable investors, rebalancing can also be coordinated with tax-loss harvesting to enhance after-tax returns.

As the time horizon expands, the probability of stocks generating gains increases materially. From 1927 to the present, the S&P 500 increased (price return does not consider dividends) on a daily basis only 52% of the time. On a rolling twelve-month basis, this jumps to 69% and to 88% on a rolling ten-year basis. If the reinvestment of dividends is included, the historical rates of gains would be higher. The total return of the S&P 500 during this period is 10.1% per year. If $100 were invested at the end of 1927, it would be worth over $800,000 -– a tremendous amount of wealth creation considering stocks only gained 52% of the time on a daily basis.

Considering these stats, most "news" should be regarded as noise. It is critical for investors to understand the risks to portfolios and keep abreast of them, but in many instances, investors should hurry up and do nothing![1] Any active deviation from the strategic allocation should be within pre-determined bands and undertaken only after a rigorous and disciplined evaluation.

For more information, please contact your Key Private Bank Advisor.

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Source: 1 - Feel free to refer to our Key Questions article "What Did We Learn in 2020?" (January 4, 2021), in which we expressed a similar view.