EMPIRICAL
ASSET MANAGEMENT

SPECIAL COMMENTARY

Asset Allocation and Bonds – Look Out Below!

- If your Financial Advisor has not at least made you aware of these new risks in the marketplace, it might be worth a conversation.
- Some Financial Advisors appreciate the risks but are frozen into not acting – status quo is easier.
- Why? Because it is emotionally challenging to suggest or effect change, especially for something that has worked for over 30 years.

"Relax and Stay Invested for the Long-Term"

Have you ever heard that before?

- Staying the course is generally sound advice, but it runs deeper than that in today's marketplace.
- It also matters **WHAT** you invest in, not just **IF** you remain invested.
- The point is, simple Asset Allocation may not work as well moving forward, as it has in the past.

How has Asset Allocation worked in the past 30 years?

- A typical Moderate portfolio was diversified with 60% Stocks and 40% Bonds.
- This was an easy solution to utilize.
- Stocks trended higher with an occasional sizeable selloff.
- Rates dropped consistently making bonds appreciate and with the reasonable yield their total return was actually better than stocks over the last 30 and 40 years.
- Bonds usually provided protection when the stock market sold off (they tended to appreciate as investors would often flee to the relative safety of bonds).
- The dollar was strong and investments in U.S. equities typically fared better than investments in international equities.
- Alternatives such as Commodities, RE, Gold, Managed Futures, Hedge Fund replication, etc. performed mediocre overall so you did not miss them in your portfolio.
- U.S. Treasury bills, notes, and bonds offered some of the highest yields of Government bonds around the globe, aiding in the strength of the dollar.

What has changed?

- COVID-19 showed up.
- The FED dropped rates to nearly 0% – rates now similar to where the rest of the world has been, with no significant yield advantage for US Government bonds any longer.
- With short term rates near 0%, US Govt. securities may not provide as good of a return opportunity as in the past thirty or more years (bond prices go up when rates go down and rates

are at historical lows). In some instances, rates will need to go negative for appreciation to occur. This is a daunting prospect.

- With short term rates near 0%, some U.S. Govt. bonds now pose a realistic chance of **Negative Returns** - whether there is inflation or not – and that is concerning.
- US Govt. bonds also no longer provide a decent yield with the 10 Year Treasury yield well under 1.5%.
- With rates near 0%, US Govt. securities may no longer provide as good of a hedge to stock selloffs as they have in the past.
- The FED increased their Balance Sheet by over $6.1 trillion.
- During the pandemic we have witnessed the fastest and largest increase by the FED in M2 (Money Supply) in history.
- The FED is buying securities of all types, increasing liquidity massively.
- There is little paper reserve currency advantage in the U.S with the low rates we are experiencing.
- GOLD is no longer only competing with the U.S. Dollar and bond yields, many think GOLD is fast becoming a significant reserve currency – GOLD has been rising in price.

Empirical's thoughts on the current investing environment

We believe it is time to adjust your asset allocation distinctly. In our current Asset Allocation Portfolios, we have done the following:

- Reduced bond exposure – sizably – particularly longer-term paper.
- Reduced exposure to traditional bonds and more toward duration managed bonds and TIPS to protect against rising rates and inflation.
- Increased our allocation to stocks, which have a solid yield compared to short term bonds.
- Increased our allocation to small-cap and mid-cap stocks.
- Allocated more to international stocks, especially emerging market stocks, and less to US stocks – to take advantage of a depreciating dollar.
- Added larger allocations to TIPS, Duration Managed Bonds, GOLD, Commodities, Managed Futures and Real Estate to hedge against higher interest rates and potential inflation caused by the large U.S. deficit.
- Significantly increased our allocation to GOLD for its return potential, hedging potential, inflation protection and reserve currency status.

At Empirical we believe that significant changes have occurred in the financial landscape. These are changes that very few investors alive today are familiar with. We do not want our clients to be caught flat-footed relying on same-old analysis and behavior and responding only after the damage is done. The principals of Empirical Asset Management have been managing Asset Allocation portfolios for over 25 years. In 2003, 2009 and now again in 2020 we have made strategic adjustments to reflect the changing times.

Empirical provides turnkey Rules Based models whose holdings are comprised of ETFs for five different risk tolerances: Conservative, Moderate Conservative, Moderate, Moderate Aggressive, and Aggressive. This allows us to create an investment portfolio that is aligned with the risk profile of our clients, while remaining cost sensitive and tax efficient.

Important Disclosures:

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Sources: Bloomberg.

For more information, including risks of investing in our strategies, visit our website at www.EmpiricalAM.com