CETERA® INVESTMENT MANAGEMENT

COMMENTARY

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Five Ways to Stay on the Road During Market Volatility

- Market swings are getting bigger as investor worries about trade gain ground.
- Although we expect a trade agreement between China and the U.S. to materialize, the heated rhetoric has increased in recent weeks.
- Outside of trade, the U.S. economy remains stable, second quarter earnings have exceeded expectations, and the Federal Reserve has taken a dovish stance.
- For these reasons, it is important to perform portfolio maintenance. We outline a five-step approach to reduce portfolio risk.

The uptick in market volatility from earlier this month has been gaining momentum. China announced this week that new tariffs will be imposed on $75 billion worth of U.S. goods. President Trump responded by asking U.S. companies to look for an alternative to China to lessen their dependency on China for goods and services. Beyond the U.S./China trade uncertainty, other factors that have driven market volatility in recent weeks include slowing global growth and Federal Reserve policy concerns. The limited volatility in the first half of the year may be more of an anomaly. We think most of the factors causing this volatility will remain intact into next year. The upcoming 2020 elections is also another factor that will start to add even more uncertainty to markets. This has many investors asking, “how do I reduce volatility in my portfolio?” By way of analogy, just like a car, portfolios need routine maintenance. A car that is not well maintained can break down more easily, doesn’t perform as well, and depreciates at a faster rate. A portfolio that is not well maintained can also run into performance issues and is exposed to additional risks, including higher portfolio volatility. One approach to reducing portfolio risk is to perform a five-step portfolio tune-up. Let’s take a look below.

1. Diagnostic Test

The first step in assessing risk in your portfolio should be to examine your risk tolerance. What are your long-term investment goals and did anything change? Schedule an appointment with your financial professional for a portfolio check-up. This check-up can involve a thorough diagnostic exam to identify any issues. It is important to discuss any life changes that have occurred that might change your financial goals. As we near retirement age, we generally reduce our risk appetite. We can no longer afford large drawdowns, because we have less time for recovery before we start withdrawing assets for income. For example, as retirement approaches, it may be time to move from a more aggressive portfolio to a moderate or balanced portfolio with more fixed income. Having a plan in place is important in times of market volatility because you can review your plan and ask yourself, “has anything changed?”.Too often, we panic in times of market stress and want to sell at the wrong time. Conversely, we like to buy stocks when they have gone up and are relatively expensive. With the U.S. presidential election around the corner, another pitfall to avoid is mixing politics and investing. This can derail portfolios. While politicians may change, your long-term investment goals typically do not – they remain the same. A car’s performance will not change

whether it is painted red or blue. The same can be said for your portfolio. You should not change your investment goals based on how you choose to vote, whether you vote red or blue.

2. Rotate Tires

After looking at your risk tolerance, you may decide that nothing has changed in your personal life and the stock/bond mix should remain the same because your risk tolerance has not changed. However, your portfolio has likely drifted if you haven't rebalanced. Like a car, your portfolio can get out of alignment. Due to the longest U.S. equity bull market in history, your portfolio may have drifted to more equities than bonds than you initially intended. Now may be a good time to talk to your financial professional about rebalancing your portfolio back to its intended target. An "out of tune" allocation can expose a portfolio to far more downside risk than that with which you are comfortable.

3. Check Under the Hood

Once you have determined your proper risk tolerance and assessed rebalancing, the next step may be to look under the hood. What is in your equity allocation? Are you overweight U.S. equities or are you diversified in emerging markets and international developed markets? U.S. markets have done well in this expansion relative to other world markets, but this hasn't always been the case. We often forget the lost decade from 2000-2009, where U.S. large cap equities were one of the only asset classes that were negative. Diversifying equity exposures and making sure there isn't any concentration risk is important.

4. Enhance Efficiency

Now that we have examined the nuts and bolts of the portfolio, another step you could take is to determine if alternative investments make sense in your portfolio. If you want a smoother ride in your car, you should optimize the car's efficiency by getting an oil change, replacing the air filter, and properly inflating the tires. Similarly, for an optimized experience in a portfolio, it is important to have some exposure to asset classes that have a low correlation to the major asset classes. Alternative strategies can help to reduce volatility in a portfolio because they can be less correlated with both equities and bonds. This can offer a smoother ride and reduce the volatility profile of the portfolio. Adding the right mix of alternatives can help reduce the impact when you run into potholes and bumps in the road.

5. Check the Brakes

Last but not least, always check the brakes! The bond allocation acts as the brakes in a portfolio. A key role of bonds is to reduce portfolio volatility. A diversified bond allocation has a much lower volatility profile than stocks historically. Bonds often produce positive returns in periods of volatility when investors seek safety from stocks. It is important to manage credit risk because there can be faulty brakes in a portfolio if there is too much credit risk. High yield bonds add diversification to a portfolio, but too much exposure can be like driving a car with worn out brakes adding to downside risk. High yield bonds typically go down in value when stocks hit periods of volatility and the losses can be sizeable. In 2008, for example, high yield bonds were down 26.2%. Too much credit risk can reduce the impact of a portfolio's brakes at the worst time. You want strong brakes if a detour takes you to a steep downhill road in heavy rain.

Ready to Hit the Road

After completing this five-step tune-up, you should be confident that your portfolio is ready to hit the road ahead. There will inevitably be detours and bumps in the road, but you will be better prepared when you encounter those obstacles, by having planned for them. Don't forget that your trusted financial professional and his or her tools and resources are here to help. You aren't alone on this journey and we will make sure you aren't asleep at the wheel.

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Glossary
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