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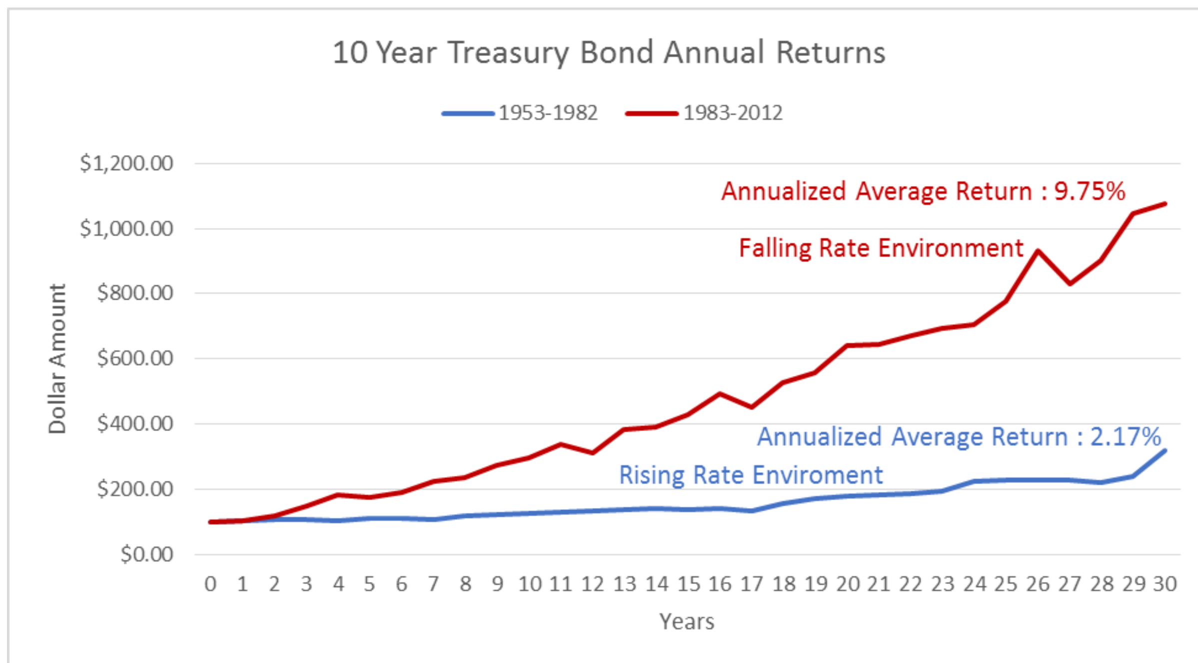
# CONSTRUCTING A CONSERVATIVE PORTFOLIO IN TODAY'S MARKET ENVIRONMENT

Conservative investors with a healthy allocation to municipal bonds have done very well for themselves over the past two decades without having to grapple with the increasing volatility in the equity markets. Rates have remained low and demand has been high – why invest in equities when the average return for a 10 year Treasury Bond has been close to 10% over the past 30 years?




However, the cycle was broken this year as a 30 year bull market in bonds finally succumbed to the prospect of a long-term rising rate environment. Many conservative investors are looking at their portfolios this year wondering what to do next. How do you generate a reasonable return these days without exposing yourself to the whims of the equity markets?

The short answer is you probably need to adjust your expectations and accept that you need to make some changes.

Here are 5 things to think about if you fall into this bucket:

1. **The days of generating 5-6% in tax-free municipal bonds are over.**
   Simply extending your maturities to reach for yield is not the right answer unless you are prepared for some significant paper losses over the next several years as rates rise. In fact, you should be using the current strength in the municipal markets to shorten your portfolios and reduce your overall fixed income exposure. *The biggest muni bond ETF (**NYSE:MUB**) lost 8.30% from May to August, hit its 52-week low in September and is -2.75% YTD, the first negative return in 5 years.*

2. **Diversification out of fixed income is mandatory.**
   If you haven't already, it is time to start looking for other asset classes to help you reach your income goals. There are a surprising variety of additional tools you can use including dividend weighted equities, MLPs, floating rate credits, and short-term junk bonds to name a few. Each of these asset classes individually should not be used as a substitute but a carefully selected, well diversified basket can actually increase yields without adding meaningful risk. *ETFs to look out for: Bank Loan Notes*

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*(**NYSE: BKLN)**, the largest ETF offering exposure to short-term bank loans with little interest rate risk and a 12 month yield of over 4.50%. MLPs (**NYSE: EMLP)** provide exposure to energy, utilities, and pipelines with a yield of 3.00% and a YTD total return of over 11%. SPDR Short-Term High Yield Bond Fund **(NYSE: SJNK)**, has an attractive 12 month yield of 5.80% with an average duration of 2.23 years.*

3. **There are such things as "conservative" equity investments.**
   Historically, equity markets are viewed as more risky than fixed income due to their historical volatility and uncertain holding periods. However, given current yields, equities are most likely going to end up being a large contributor even in a conservative asset allocation. There are several interesting options for conservative investors seeking to participate in the equity markets but with some level of downside protection even if it means sacrificing some of the upside. *ETFs with reduced volatility (**NYSE: USMV)** use a rules-based approach to select stocks in the S&P 500 with lower volatility. **USMV** is up over 21% for the year with a downside market capture of fewer than 80% (Morningstar). Consumer Staples ETFs (**NYSE:XLP)** are generally affected much less by economic climate changes. **XLP** is up over 16% for the year with a yield of 2.77%.*

4. **Asset allocation is still determining driver of risk and return – both of which should be balanced against your actual long-term goals.**
   Conservative investors, by definition are looking to take as little risk as necessary to meet their long-term financial goals, net of fees, net of taxes, and most likely in real dollars (so net of inflation). Since yields are still historically low, any investor with cash flow needs, regardless of age or risk tolerance, will need to focus on total returns. Therefore, it is critical to spread out your "risk budget" into multiple buckets and pay attention to macro trends. For example, you can allocate to international equities to diversify your US economic and currency exposure while taking advantage of a continued European recovery. *A satellite position might be small cap international equities (**NYSE:SCZ)**, which are up over 20% on the year.*

5. **Beware of investments that don't provide income.**
   Many investors and their financial advisors have continued to invest in assets that have little to no yield and are billed as hedges against market downturns. In other words, they are well suited for conservative investors since they help soften an equity correction. However, these investments still go down, sometimes significantly. Investments in commodities especially gold and other inflation hedging securities are clear examples this year. (***NYSE: TIP, GLD, DJP)*** have all posted major losses this year with gold down -21.00% in the last year.

Ultimately, risk adjusted returns define the type of investor you are or think you are. The higher the risk, the higher the expected return should be. Until recently, conservative investors have been able to achieve their modest return objectives primarily using diversified municipal bonds which have not carried a whole lot of volatility or credit risk. However, this year has changed that equation and effectively normalized the playing field. Conservative investors either need to diversify and assume more risk to achieve their return objectives, or live with lower expectations.

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