TDI Podcast – Guest, Tom Nelson (#894)

Quick recap

Andrew and Tom discussed the importance of asset allocation in managing investment portfolios, emphasizing the need for balancing risk and reward based on individual financial goals and risk tolerance. They also explored the concept of a "mosaic" approach to analyzing portfolios, considering various factors such as economic growth, inflation, interest rates, policy, and sentiment. The conversation also covered the current state of the economy, the stock market, and the potential impact of the Federal Reserve's actions on interest rates and housing affordability.

Summary

Asset Allocation and Risk Management

Andrew and Tom discussed the importance of asset allocation in managing investment portfolios. They emphasized the need for balancing risk and reward based on an individual's financial goals, risk tolerance, and investment horizon. Tom highlighted the benefits of diversification, stating that investing across asset classes can produce a smoother return stream through reduced risk without sacrificing equivalent levels of expected returns. He also mentioned the Franklin Moderate Allocation Fund, which has delivered 88% of the returns of stocks with 65% of the risk over the last 28 years. They also discussed the concept of risk-adjusted return, with Tom explaining how they use long-term return expectations and strategic asset allocation to guide their investment decisions. Andrew brought up the use of statistical measures like the Morningstar risk-adjusted returns to compare funds or strategies with similar objectives.

Dynamic Asset Allocation and Mosaic

Andrew and Tom discussed the importance of asset allocation and its dynamic nature. They agreed that asset allocation should not be a set-it-and-forget-it strategy, but rather a flexible approach that changes based on economic factors. They also discussed the concept of a "mosaic" - a multidimensional approach to analyzing portfolios that takes into account various factors such as economic growth, inflation, interest rates, policy, and sentiment. Andrew appreciated the term "mosaic" over "matrix" for its artistic and multidimensional connotations. They concluded that while there is no perfect answer to tactical investing, a flexible approach that considers various factors is essential.

Portfolio Risk and Reward Measures

Tom Nelson discussed various measures of risk and reward in portfolio management, including tracking error and information ratio. He explained that tracking error measures how closely a portfolio's positioning aligns with a benchmark, while the information ratio measures the active return achieved relative to the benchmark risk taken. Tom emphasized the importance of calibrating these measures based on their views of the world and the risk associated with each investment decision. He also highlighted the need to measure these factors before and after making investment decisions. The discussion was set to continue with a focus on macro inflation and the Fed's actions.

Economy and Stock Market Discussion

Andrew and Tom Nelson discussed the current state of the economy and the stock market. They noted that the economy is running fine, with good GDP numbers, manufacturing and service numbers, consumer confidence, and job numbers. They also discussed the recent sharp rally in the S&P 500, which has been one of the greatest risk-adjusted yearly returns in its history. However, they also acknowledged that the Fed has been aggressively hiking interest rates to combat inflation, and that the job of controlling inflation is mostly done. They concluded that the probability of a recession over the next 12 months is quite low.

Interest Rates, Housing Affordability, and Gold

Tom discussed the current high short-term interest rates and their impact on housing affordability. He suggested that the Federal Reserve could reduce these rates, which would be beneficial for corporations and potentially lead to economic growth. However, Andrew countered that lowering rates might not necessarily lower housing prices, as it could lead to more people buying houses and thus increasing prices. They also discussed the rising gold prices and the potential for inflation, with Tom noting that the Federal Reserve needs to be cautious not to overheat the economy. Andrew expressed concern about the timing of gold investments, citing past instances where gold prices declined significantly.

International Equities and US Performance

Andrew and Tom also discussed the performance of international equities and US equities. Andrew questioned the necessity of including international equities in a portfolio, given their historical underperformance. Tom Nelson responded that while the US has outperformed the rest of the world since the global financial crisis, over the longer term, international equities offer diversification and lower risk. He also noted that the US is currently more expensive than the rest of the world, which could reduce expected returns. Tom concluded that diversifying some US exposure into the rest of the world makes sense, but the current environment is one of resilience with different regions moving at different speeds, led by the US.