"Stay the Course" doesn't mean "Do Nothing"

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The NFL conducted the 2020 Draft virtually with record audiences tuning in with the usual unrealistic hopes, some head-scratching and opinions ranging from highly informed to……. Well, you know what they say about opinions. I love the draft. We might not know which teams did well or did poorly for several years, but every team did something. Generally, the teams that do the best are the ones that are already pretty good despite the inverse draft order in proportion to the order of final rankings in the prior season. These teams have a plan. Rather than seeking a bright and shiny star to reverse past frustration like magic, the draft is just one component of a process designed to build the team they want. These teams have taken a thorough inventory of the talent they already have; identified their needs and weaknesses; evaluated options such as trades and free agency; and made tough decisions about who to let go from an already good team in order to be better in the years to come. In other words, they have been working all along toward a coherent goal. The NFL is set up to be a level playing field, but there are relatively few examples of teams completely reversing trajectory through the draft alone. "Brilliant moves" are really a combination of diligence, adherence to a plan and a little bit of luck. While it is true that great teams always have great players, the inverse is not true; a few great players do not make a great team.

Portfolio management is similar in many ways: limited resources, similarly informed participants, challenging decisions, lots of distractions, friction and sentiment created by the past. Truxton's process is designed to build durable, diversified portfolios that seek to compound wealth consistently over time with a great deal of tax efficiency. Fortunately, the portfolio management process doesn't receive as much fanfare as the NFL draft. Afterall, it isn't very exciting, but we do believe it is important and worth meaningful consideration. My own children have asked me with wrinkled eyebrows: what is it exactly that you do?

We thought many of you might have the same question when we commonly recommend: “stay the course.” That does not mean doing nothing.

Growth oriented investments in a Truxton portfolio are comprised of investments in individual businesses or companies we feel have durable characteristics. We believe that reasonable utilization of debt, relatively consistent revenue growth, healthy profitability and a history of strong cash flow are attributes that make companies durable across varying economic environments. We believe the focus on durability allows the opportunity to manage volatility and downside risk while maintaining a well-reasoned, long-term investment perspective even during trying times. We believe that good portfolio outcomes are a result of discipline, consistent diligence and a willingness to recognize and accept when things have changed. In short, the process of implementing portfolio changes requires a “measure twice and cut once” approach. While diversified portfolios of durable businesses are not immune to unpleasant market corrections, these corrections do present opportunities to improve a portfolio’s forward risk and return characteristics. Such opportunities include adding to new and existing investments in durable businesses selling at more attractive entry points and reducing or eliminating existing investments that have grown outsized, have elevated valuations or are expected to have deteriorating fundamentals. We have implemented more individual portfolio changes than usual during the downturn. Additionally, we have recently reduced equity exposure to International Developed and Emerging Markets in favor of U.S. Large Cap equities in Truxton’s individual equity strategies (Large Cap Core and Equity Income). This change reflects our desire to increase high-quality U.S. assets at more favorable entry points and the attractiveness of the relative strength and resilience of the U.S. economy.

Truxton utilizes investment grade bonds to generate current income, provide portfolio stability and mitigate equity market volatility. While the investment grade bond market is stable relative to the equity markets, at times, market conditions do present attractive investment opportunities. We have seen episodes during this correction during which municipal bonds became a relative value for clients that don’t usually purchase municipal bonds and corporate bonds became a relative value for clients that usually purchase municipals. We have taken advantage of these opportunities.

Downturns are a good time to clean house. We have seen many opportunities to remove certain legacy mutual funds, reduce concentrations and abandon some stocks where gains had been a significant consideration. Mutual funds are fine for most investors, but for wealthy investors, we believe there is a better way. The embedded fees are significant and the annual practice of distributing capital gains, even when investment returns are negative, often produce large and unwelcome tax surprises. We believe individual stocks, bonds and ETFs offer more flexibility and tax efficiency. Concentrations are always a risk; however, plans to diversify usually take time in order to spread capital gains over tax years. The correction has offered opportunities to move faster in some cases. Finally, there are some stocks that just don't offer much potential; however, they create friction due to unrealized gains or sentiment that tells us: this one has done a lot for me. Downturns are a great opportunity to make long-needed changes to put your portfolio in a better position for the future. We have done a lot of this.

As stated above, we have made a great deal of changes recently to better position portfolios in the coming years. If there is a silver lining in the recent market correction, it's that these changes have been made in a tax advantageous manner. In implementing these changes, we have realized losses to offset realized capital gains to reduce tax liabilities. A tax loss provides flexibility to diversify more aggressively and to limit taxable gains when we need to rebalance or raise cash for distributions in the future. We have captured losses earlier in the year than we typically would without reducing desired exposure.

Good execution during times like this requires being in a good position initially. Overhauls rarely go well. Do you really know your most basic criteria? If it is an NFL scout or GM these include measurable and immeasurable attributes of the players and what you expect them to do for your team. For a portfolio manager, the criteria are the types of assets you will include and what you expect from them in terms of both risk and return. It is a lot easier to make valuable changes when you don't have to make as many of them. If you aren't back-pedaling from poor decisions and inadequate maintenance then you don't have as many decisions to make. More importantly, you don't have to make them in a hurry. Adhering to disciplined criteria won't guarantee outperformance every quarter, but it will keep you in a position to compound after-tax returns over time with a higher degree of consistency and to spend the difficult times focused on upgrades rather than a whole new strategy. ■