



Wealth Strategies

Asset Allocation





Wealth Strategies: **Asset Allocation**

At its most basic, asset allocation provides the rudimentary foundation upon which an investment portfolio is built. To help provide a picture of how important asset allocation truly is, we can look at it like the foundation of your home. Without the foundation, your home wouldn't stand for long. It is the most integral part of your home, and no other components or rooms of your

house would be able to be constructed without it. The same should hold true for your investment portfolio.

If you don't have a solid foundation for your portfolio, how can you build and construct a solid portfolio meant to endure the years leading you to and through your retirement?

Here's how Investopedia defines asset allocation:

“An investment strategy that aims to balance risk and reward by apportioning a portfolio's assets according to an individual's goals, risk tolerance, and investment horizon. The three main asset classes—equities, fixed-income, and cash and equivalents—have different levels of risk and return, so each will behave differently over time.”

So What Does That Mean?

By altering the percentage of your portfolio invested in stocks (high risk and high return), bonds (low-to-moderate risk and return), and cash (negligible risk and currently negligible return), you can tailor the portfolio's risk and return profile to meet your specific needs.

Let's take a quick step back to the basics. Traditional assets include stocks, bonds, and cash. Stocks (also known as equities) represent ownership interest in a company. Bonds (also known as fixed income) are promissory notes issued by a company to raise debt capital. When a company issues a bond, it promises to pay the



investors (bondholders) a specified amount of interest for a specified length of time and then repay the principal loan amount on the bond's maturity date. And cash is just that, cash or a deposit account. So, broken down, one can allocate his or her investment portfolio into a mix of stocks, bonds, and cash in order to achieve a certain balance between risk and return.

To understand the importance of asset allocation, we must look back at history. In 1952, Harry Markowitz's article "Portfolio Selection" introduced Modern Portfolio Theory, which asserted that a portfolio should be evaluated based not on the merits of the individual securities themselves but rather on how these securities interact with each other (their correlation). This theory put forth the notion that a portfolio could be optimized by combining assets (or asset classes) that are not highly correlated, thereby reducing the overall risk taken by an investor relative to an expected rate of return. To this day, fundamental portfolio architecture is based on this theory. One of the primary benefits of Modern Portfolio Theory is the ability to reduce the probability of severe downside risk while maintaining the ability to achieve reasonable long-term returns. Further research on the topic was released in 1986 by Brinson, Hood, and Beebower, titled "Determinants of Portfolio Performance." In this article, they attempted to measure the true impact of asset allocation on a portfolio's risk and return profile. Their claim was that more than 90% of the variation of returns on a portfolio is determined by how the assets are allocated (versus sitting in cash). Later studies by Ibbotson and Kaplan challenged these findings but still concluded that asset allocation accounted for 40% of the variation of returns. Either way, it's clear that a significant portion, whether 40% or 90%, of a portfolio's risk and return can be attributed to asset allocation alone. The result of these findings is the now common practice of combining the three traditional asset classes (stocks, bonds, and

cash) in various proportions. This allows investors to customize portfolios to better fit their particular needs, depending on the levels of risk and return required.



Risk

Generally speaking, one would assume that the expected return of a portfolio is the weighted average of the expected returns of all underlying securities (within each portfolio). However, Modern Portfolio Theory argues that portfolio risk is not a function of the weighted average of each underlying security's expected risk. It argues that portfolio risk is less than the average risk of the underlying securities if their returns are not perfectly correlated. The less correlated the returns of the underlying securities, the greater the reduction in the portfolio's overall risk. Unlike risk, the return side of the equation is not diluted by the assets being less correlated. This can be viewed as a win-win proposition. A classic example is the blend of stocks and bonds, which in "typical" market environments are lowly or negatively correlated. The combined return is the average of the two, but the risk is far less than the average because the two tend to offset one another, as one typically rises when the other falls. It should be noted, however, that there are instances when both do move in the same direction. The allocation among the two

asset classes is a long-term strategy that should not be measured by shorter periods of disruption to the long-term trend. Modern Portfolio Theory thus provides a practical framework whereby investors can allocate their financial resources to multiple asset classes in order to maximize their portfolio's long-term risk and return dynamics.

Asset allocation is only the first step in the portfolio construction process. Because a typical investment portfolio consists of only the three traditional asset classes, and sometimes a fourth alternative class, more work is required in order to provide the diversification needed to build a sound portfolio.

Diversification

Let's think back to our earlier analogy of building a home. You've built the foundation of your home, but now it needs to be structured to be functional to you. It's time to decide how to utilize the space most efficiently to meet your needs. Diversification within your portfolio is very similar. When you built your portfolio, you divided your portfolio into a percentage of stocks, bonds, and cash. You must now diversify the assets within those allocations by splitting the funds among various asset sub-classes and/or sectors.

Basically, by increasing the number of individual investments within the portfolio, you can reduce the overall risk of the portfolio. The reason is that through proper diversification, no single investment would hold a significant enough proportion of the overall portfolio value to severely damage the portfolio if it were to lose a substantial amount of its value.

The benefits of diversification are similar to those of asset allocation. Adding diverse, uncorrelated assets to a portfolio reduces the overall level of risk. Specifically, the risk being reduced is referred to as unsystematic risk, or the risk of an individual investment, not general market risk.

The main difference between asset allocation and diversification is that diversification focuses more on the volume of securities within the portfolio.

Many academic studies have shown that a portfolio of at least thirty individual investments is adequate for diversification purposes, so long as the securities are not highly correlated. The initial process of general asset allocation can only provide a few broad strokes of diversification. Diversification itself, however, is the next integral step to building a portfolio in which you determine the various asset sub-classes or economic sectors that will be represented within each asset class.



Here's how Investopedia defines diversification:

“A risk management technique that mixes a wide variety of investments within a portfolio. The rationale behind this technique contends that a portfolio of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio. Diversification strives to smooth out unsystematic risk events in a portfolio so that the positive performance of some investments will neutralize the negative performance of others. Therefore, the benefits of diversification will hold only if the securities in the portfolio are not perfectly correlated.”



Asset Sub-Classes for Stocks May Include the Following:

■ Large-Cap Value Stocks

Stocks of companies with a cumulative value of all outstanding shares equaling greater than \$10 billion that are valued cheaply relative to the companies' fundamentals, such as earnings and net asset value. These tend to return much of their profits to investors in the form of higher dividends.

■ Small-Cap Value Stocks

Stocks of companies with a cumulative value of all outstanding shares equaling less than \$2 billion that are valued cheaply relative to the companies' fundamentals, such as earnings and net asset value. These tend to return much of their profits to investors in the form of higher dividends.

■ Large-Cap Growth Stocks

Stocks of companies with a cumulative value of all outstanding shares equaling greater than \$10 billion that are more expensive from a valuation perspective because investors are willing to pay for the higher growth rates of their businesses, which they hope will lead to

better returns in the future. These tend to pay smaller dividends (or no dividends at all), with management preferring to reinvest profits in order to continue fueling growth.

■ Small-Cap Growth Stocks

Stocks of companies with a cumulative value of all outstanding shares equaling less than \$2 billion that are more expensive from a valuation perspective because investors are willing to pay for the higher growth rates of their businesses, which they hope will lead to better returns in the future. These tend to pay smaller dividends (or no dividends at all), with management preferring to reinvest profits in order to continue fueling growth.

■ International Stocks

Stocks of companies based in foreign countries.

■ Economic Sectors

These include basic materials, consumer discretionary, financial services, communication services, energy, industrials, technology, consumer staples, healthcare, and utilities.

By selecting your master stock allocation across various asset sub-classes and/or sectors, a more disciplined process is in place to ensure proper diversification of the portfolio. It's important to remember the old adage, **"don't put all your eggs in one basket."** It's not enough to say that thirty stocks are needed for diversification and then invest in thirty different technology stocks. These stocks would all have a relatively high correlation to one another. Rather, one must invest in different sectors with low overall correlation to achieve higher success through diversification.

The ultimate decision of which asset sub-classes or sectors one should invest in is ultimately determined by the needs of the investor. Is the investor tax-sensitive or tax-exempt? Is the investor looking for current income to cover retirement living expenses, or is he or she seeking pure growth?

For example, if an investor's target allocation is determined to be 50% stocks and 50% bonds but she does not want taxable income, what are the best types of securities to put into that portfolio? Perhaps non-dividend-paying growth stocks from

diverse economic sectors fit the bill for the stock portion and tax-free municipal bonds are a good choice for the bond portion. Once the allocation percentages have been assigned to each of these categories, the categories then need to be filled with actual securities.

Security Selection

We'll round out our discussion by going back to our original analogy of building your home. The foundation has been laid, the home has been constructed into rooms that make sense to the homeowner, and now furnishings must be purchased to fill each room of the home. The same can be said about security selection.

Security selection is the self-explanatory final step in the process in which individual securities are identified that fit into each of the portfolio's allocated categories. This step can also be the most complicated, as it is where fundamental research comes into play. Here, one must analyze which stock has the most promise within a particular sector where exposure is desired. Which company has the strongest balance sheet or best competitive advantage? Which stock has the most consistently growing dividend payout? There are limitless parameters that can be set, and different methodologies can be used to select individual securities for investment. There are many options to choose from when filling the portfolio framework with individual securities. There are different

schools of thought and different managers with different styles and strategies to select the best securities for a particular portfolio. These are beyond the scope of this paper, but the key for long-term success is to focus on quality and avoid speculation.

Conclusion

Proper portfolio construction is both art and science. It requires the ability to apply long-term statistical data with discretion to make adjustments for current and anticipated conditions. For example, if historical data would indicate that an investor's objectives would be best met with an allocation of 40% stocks and 60% bonds, but current and forward-looking market conditions appear to differ from those historical averages (as in today's exceptionally low interest-rate environment), a discretionary adjustment to a 50% stock and 50% bond allocation may be the artful answer. But it is the disciplined structure of asset allocation supported by Modern Portfolio Theory that provides the framework for long-term successful investing.

As with all things financial, there is no one cookie-cutter solution. Each individual investor must weigh his or her assets and goals for those assets in order to make the most informed decision. Consulting a financial professional who has a proven process of asset allocation, diversification, and security selection is of utmost importance in order to develop a plan that can help you chart a path to financial success. ■





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