Wealth Strategies

Asset Allocation: The Building Blocks of a Sound Investment Portfolio

Part 6 of 12
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 think of it as 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?

Technically speaking, Investopedia defines Asset Allocation as:

“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 portfolios 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 their 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. His theory asserted that a portfolio should be evaluated based not on the merits of the individual securities themselves, but rather 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 over 90% of the variation of returns on a portfolio are 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 is 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 each investor 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 security’s (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. 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 since 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 they do move in the same direction. The allocation amongst the two asset classes is a long term strategy that should not be measured by shorter periods of disruption to the longer 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.

Most recently, due to increased selection and availability, investment managers are including a fourth asset class in portfolios referred to as alternative investments. This is a broadly defined category that includes real estate, hedge funds, private equity, commodities, and other non-traditional investments. The inclusion of this fourth asset class further reduces the risk of the portfolio and has the potential to increase returns.

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 three by splitting the funds among various asset sub-classes and/or sectors.

Investopedia defines Diversification as:

“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.”

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.

Asset sub-classes for stocks may include:

• **Large-cap value stocks:** Stocks of companies with a cumulative value of all outstanding shares equaling greater than $10 billion, which are valued cheaply relative to the companies’ fundamentals such as earnings and net asset value. They also tend to return more 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, which are valued cheaply relative to the companies’ fundamentals such as earnings and net asset value. They also tend to return more 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, which are more expensive from a valuation perspective because investors are willing to “pay-up” for the higher growth rates of their businesses leading to better returns in the future. They tend to pay smaller to no dividends because management prefers to reinvest their profits back into the businesses to continue to fuel their growth.

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• **International stocks**: Stocks of companies based in foreign countries.

• **Economic sectors 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 is important to remember the old adage “don’t put all your eggs in one basket”. It is not enough to say that thirty stocks are needed for diversification and then to 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 decisions of which asset sub-classes or sectors one should invest in are ultimately made 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 are they 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 for the bond portion. Once the allocation percentages have been assigned to each of these buckets, the buckets 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 most 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.

Securities Selection is the self-explanatory final step in the process in which individual securities are identified that fit into each of the portfolios allocated buckets. It can be, however, the most complicated. This is where fundamental research comes into play by analyzing which stock has the most promise within a particular sector that you want exposure to. 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 that can be used to select individual securities for investment. There are many options to select 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% stocks and 50% bonds 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/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 should be of upmost importance in order to develop a plan that can help you chart a path to financial success.
About RFA

Reilly Financial Advisors is a fee-only Registered Investment Advisor, aimed at helping our clients both define and achieve their individual financial goals through four unique service offerings:

1. **Wealth Building** – for those still accumulating their investment portfolios

2. **Wealth Management** – for those who have amassed their savings and have specific needs associated with their wealth

3. **Wealth Legacy** – for those who have accumulated a significant amount of wealth and face unique wealth transition needs

4. **Corporate Retirement Services** – tailored solutions for plan sponsors and participants

RFA, founded in 1999, services clients around the United States and in more than a dozen countries worldwide. As an independent advisor, we are able to provide our clients with the highest level of Fiduciary services which allows us to make investment decisions based solely in the best interest of our clients. Our goal is to be our client’s first point of contact for all of their financial needs, serving as a trusted financial partner for the long term.