Perspectives
First Quarter 2017

Asset Allocation 101

By Martin Landry, CFA, CFP®, CAIA, CIMA®, CIPM, AIF®, Manager IMRG, Senior Portfolio Manager, 1st Global

Asset allocation involves dividing an investment portfolio among different asset categories, such as stocks from U.S. and foreign companies, bonds from governments and corporations, and cash or money-market funds.

Determining which mix of assets to hold in your investment portfolio is a very personal process and depends on how long you plan to invest, what you are trying to achieve with saving your money and investing it, and even how patient or anxious you are when the value of your total investments rises and falls with the course of the markets and time. Thus, the asset allocation that works best for you at any given point in your life will generally be determined by your time horizon and your risk tolerance.

Your time horizon is the expected number of months, years or decades during which you will invest to achieve a particular financial goal. An investor with a longer time horizon may feel more comfortable taking on a riskier or more volatile collection of investments because he or she can wait out slow economic cycles and the inevitable ups and downs of the markets. By contrast, an investor saving for a down payment on a house would likely take on less risk because he or she has a shorter time horizon.

Risk tolerance is your ability and willingness to lose some or all of your original investment in exchange for greater potential returns. An aggressive investor (one with a high risk tolerance) is more likely to risk losing money in order to obtain better results. A conservative investor (one with a low risk tolerance) tends to favor investments that will preserve his or her original investment.

When it comes to investing, risk and reward are generally entwined. You've probably heard the phrase "no pain, no gain" — words that come close to summing up the relationship between risk and reward. All investments involve some degree of risk, and if you intend to purchases securities — such as individual stocks or bonds or even mutual funds, which are pooled collections of securities — it's important that before you invest you understand that you could lose some or all of your money.

During most cycles of the markets, the reward for taking on risk is the potential for a greater investment return. If you have a financial goal with a long time horizon, you generally have a greater likelihood of making more money by carefully investing in asset categories with greater risk (e.g., foreign stocks or high-yield bonds), rather than restricting your investments to assets with less risk (e.g., government Treasury bills).

By including asset categories with investment returns that move up and down under different market conditions within a portfolio, an investor can protect against significant losses. Historically, the returns of the major asset categories have not moved up and down at the same time. Market conditions that cause one asset category to do well often cause another asset category to have average or poor returns. By investing in more than one asset category, you'll reduce the risk that you'll lose money, and your portfolio's overall investment returns will have a smoother ride. If one asset category's investment return falls, you'll be in a position to counteract your losses in that asset category with better investment returns in another.

The practice of spreading money among different investments to reduce risk is known as diversification, which is analogous to the age-old adage "Don't put all of your eggs in one basket." At its core, diversification allows investors to reduce business-specific risk, meaning the fortunes of any single company will not have a significant impact on an investor's fortune. Naïve investors often practice diversification by selecting more than one financial advisor, and naïve financial advisors often practice diversification through product proliferation.

Some financial experts believe that determining your asset allocation is the most important decision that you'll make with respect to your investments.

By selecting the appropriate group of investments, you may be able to limit your losses and reduce the fluctuations of investment returns without sacrificing too much potential gain. There should also be a balance regarding the amount of risk within your portfolio. If you don't include enough risk in your portfolio, your investments may not earn a large enough return to meet your goal. For example, if you are saving for a long-term goal, such as retirement or college, you will likely need to include at least some stock or stock mutual funds in your portfolio. On the other hand, if you include too much risk in your portfolio, the money for your goal may not be there when you need it. A portfolio heavily weighted in stocks or stock mutual funds, for instance, would be inappropriate for a short-term goal, such as saving for a family's summer vacation.

Some financial experts believe that determining your asset allocation is the most important decision that you'll make with respect to your investments — that it's even more important than the individual investments you purchase. Contact your financial advisor to help you determine your initial asset allocation and suggest adjustments for the future.

Neither asset allocation nor diversification protects against a loss in declining markets.

Navigating the New Normal: Fixed-Income Investing in a World of Mounting Risks

By John Hancock Investments

In today's fixed-income environment, where anemic yields have become the norm, investors everywhere are facing similar challenges. Whether seeking incremental returns, helping to protect against rising interest rates or diversifying away from domestic bond markets, investors are struggling with how to best design their fixed-income portfolios to achieve their financial goals. Traditional domestic fixed-income strategies have historically delivered competitive returns with lower volatility, but given their current low yields, higher duration characteristics and the upward pressure on shorter-term interest rates, it's unlikely those strategies will deliver the same risk-reward profile going forward.

One obvious option available to investors is to significantly reduce their fixed-income exposures. However, by abandoning bonds and moving to other asset classes for the sake of generating returns, investors are courting higher volatility and a possible loss of capital — hardly an attractive trade-off.

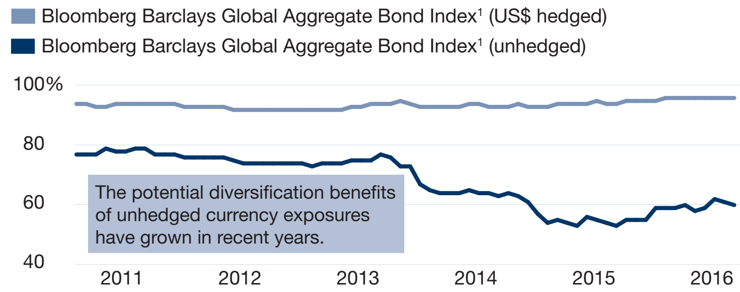
Another flawed option is to simply alter the mix of securities held in a portfolio. Increased static allocations to high-yield bonds, floating-rate debt or emerging-market debt, for example — some of the higher-yielding options available in today's market — undermine one of the key benefits fixed income brings to a portfolio: the asset class's ability to dampen overall volatility, especially risk stemming from equity exposure. Meanwhile, those segments of the bond markets with the lowest correlations to equities — short-term credit and mortgage-backed securities — have high correlations to the interest-rate-driven Bloomberg Barclays U.S. Aggregate Bond Index. Ultimately, there are no free lunches when it comes to sector allocation within a fixed-income portfolio. The third option — and we believe the best — is for investors to dedicate portions of their fixed-income assets to strategies with broader guidelines and increased manager discretion; a focus on overall volatility rather than risk versus a stated benchmark; and exposure to nontraditional sectors that may offer greater diversification, yield and total return opportunities.

Currency Is Key to Unlocking the Diversification Benefits of Global Bonds

By allocating to strategies with broader opportunity sets, investors are able to immediately gain exposure to wider ranges of geographic regions, countries, sectors, currencies and credit qualities while also adding layers of diversification away from domestic interest-rate risk. But here, there is an often underappreciated caveat: The diversification benefits of a global opportunity set are directly tied to the underlying currency exposures; hedging away all currency risk virtually eliminates the diversification benefit of a global allocation. Unhedged positions, on the other hand, have shown much lower — and falling — correlations to the U.S. bond market over the past five years.

Hedging Away Currency Risk Means Sacrificing Diversification Benefits

Rolling 5-year correlations versus the Bloomberg Barclays U.S. Aggregate Bond Index



Source: Manulife Asset Management, Aug. 31, 2016

While a fully unhedged mandate provides a diversification benefit, completely embracing currency risk exposes investors to the high volatility of local currency markets, which have historically been the primary driver of performance in a global bond portfolio. The sweet spot for investors, we believe, lies in actively managing currency exposure, embracing currency risk among strengthening foreign currencies and mitigating it among those that are weakening. This approach can still provide the diversification benefits of an unhedged global portfolio but with a potentially lower volatility profile.

Rising U.S. Interest Rates Underscore the Need for Broader Horizons

In today's fixed-income landscape, defined by extraordinarily low yields, conventional high-quality bond strategies are no longer sufficient to meet investors' return objectives. Such high-quality fixed-income assets will continue to offer investment benefits, such as potentially adding diversification to an equity-oriented portfolio, dampening total portfolio volatility and providing liquidity in stressed markets.

We believe a more calculated approach is necessary within a fixed-income allocation. Rather than ride the highs and lows of a static benchmark allocation, global multi-sector strategies can seek out the best parts of the market and, just as important, help avoid those parts of the market that present the most risk altogether. By actively navigating the opportunities in the currency markets, a portfolio with a global scope may add significant diversification away from domestic rate-driven risks — a key feature for any bond allocation in today's rising-rate environment.

[1] The Bloomberg Barclays Global Aggregate Bond Index tracks the performance of global investment-grade debt in fixed-rate Treasury, government-related, corporate and securitized bond markets. Prior to Aug. 24, 2016, the index was named the Barclays Global Aggregate Bond Index. Hedged returns for the index do not reflect the effects of currency fluctuations on foreign-denominated securities. It is not possible to invest directly in an index.

1st Global® RESEARCH & CONSULTING

12750 Merit Dr., Ste. 1200, Dallas, TX 75251 | www.1stGlobal.com | 877-959-8400