William Blair

Private Wealth Management
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Asset Allocation: Your Biggest Investment Decision

Building and managing a portfolio is a continual process that involves numerous decisions. But none of those decisions is more important than how you allocate your wealth across different asset classes.

Introduction

Your financial plan is a road map for achieving your personal goals throughout your lifetime. It encompasses a variety of planning areas such as income and cash flow, retirement goals, charitable giving, taxes, estate structure, and wealth transfer. For many, however, the most important aspect of financial planning is developing an asset allocation strategy that is aligned with your risk tolerance, time frame, and financial resources.

William Blair's Dynamic Allocation Strategies team co-published a study[1] in 1991 that found that 91.5% of the variability of a portfolio's returns is attributable to asset allocation.

The simple definition of "asset allocation" is how much of your portfolio is invested in each of the various asset classes, such as cash, stocks, and bonds, as well as real estate or other alternative assets.

The appropriate asset allocation strategy for you will depend on your risk tolerance and the return you hope to achieve to meet your goals. Your risk tolerance will also be influenced by your time frame for achieving your goals, your financial situation, and your personal feelings about money and investing. By developing and implementing an asset allocation strategy that fits your particular goals and situation, you can take more control of your financial plan.

To help you think strategically about asset allocation, this paper will examine:

- Developing your strategy
- Achieving meaningful diversification
- Monitoring your allocations and reviewing your plan

1 Determinants of Portfolio Performance II: An Update, by Gary Brinson, Gilbert Beebower, and Brian Singer. (1991)

Developing Your Strategy

There is systematically prescribed asset allocation for an individual investor. Each investor needs to consider his or her own tolerance for risk, their unique financial and tax situation, and most importantly, their long-term goals and objectives. The right balance for one investor will not necessarily be the right balance for another. What follows is a closer look at some of the factors to consider as you work with your wealth advisor to develop an asset allocation strategy that is tailored to your unique needs.

Defining Your Goals

The first step in developing an asset allocation strategy is to articulate your goals. Consider core goals such as your vision of retirement, the extent to which you want to transfer wealth to family members, and your philanthropic objectives. Also consider dreams you may want to pursue, such as starting a business, owning a vacation home, or creating a family legacy.

Next look at how much money each goal will require. If your goal is to buy a vacation home in two years, you may already have an accurate idea of what the likely cost will be. If the goal is further down the road, such as maintaining your current lifestyle when you retire in 20 years, it may be harder for you to determine. Your William Blair wealth advisor can help you develop realistic estimates of the resources needed for each goal.

Assessing Your Risk Tolerance

The time frame for a particular goal may have a major impact on your risk tolerance. A longer time frame gives you more opportunities to recover from an investment loss. Therefore, in many cases a longer time frame could be conducive to a higher risk tolerance. For example, you likely will want to be more conservative with money you are investing to buy a vacation home in two years than with money you are investing for retirement in 20 years.

Also think about your current and future cash-flow and liquidity needs. Needing income or liquidity from your portfolio in the short term may reduce your risk tolerance and also shift the focus to income-producing assets. On the other hand, if you are earning significant income or have substantial liquid assets outside the portfolio, you likely have a greater ability to weather short-term market volatility.

Weighing Other Factors

Taxes

Taxes on capital gains, dividends, and ordinary income play a significant role in determining how much of your portfolio you actually get to keep. Enhancing the tax efficiency of your portfolio should be an important element of your asset allocation strategy. For example, investors in the highest tax bracket may want to allocate more assets to tax-exempt municipal bonds or to equities that will produce long-term capital gains rather than to taxable bonds or other investments that are taxed at the highest marginal rate. Similarly, if you have a Roth IRA, it may be advantageous to place higher growth investments in that account in order to take advantage of the tax-free compounding over time. This step of locating investments in specific account types, or “asset location” can have a significant long-term impact on future asset values.

Concentrated stock positions

If you are a business owner or corporate executive, a large percentage of your wealth may be tied to the fortunes of a single company. In addition to receiving much of your income from the company, you may also have large holdings in company stock or stock options. To achieve an appropriate risk/return profile, your asset allocation strategy must account for existing concentrated equity positions and any restrictions on the sale of the stock. It may make sense to balance a concentrated exposure by creating a conservative portfolio that, when blended together with your equity in the business, could reduce overall risk exposure.

> “Your time frame is often directly related to your ability to assume risk. The longer you have until you need the assets, the greater your ability to weather short-term market volatility.”

By carefully building your portfolio around the existing position and industry exposure, you can reduce the risk of overconcentration in an industry or sector. Hedging through the use of options may provide another method for managing single-stock risk within a diversified portfolio.

Personal values and beliefs

Your personal feelings about money and investing will affect your risk tolerance. You may by nature be a risk taker, or you may be innately risk-averse. Your selection of particular investments can also take into account your personal values and beliefs. Some investors may restrict certain businesses, sectors, or industries from their portfolios, or incorporate "ESG" considerations (Environmental, Social, Governance).

Whatever your values and beliefs about money, it is important to develop an asset allocation strategy that will help you achieve your goals and allow you to sleep at night.

Evaluating Potential Strategies

Once you have identified your financial goals, risk tolerance, and other parameters that will affect your asset allocation strategy, you can begin examining a range of potential asset allocation strategies with varying projected risk/return profiles.[2] In considering the various allocation choices, you and your advisor may discuss the statistical probability of each portfolio achieving your goals. The focus should be on seeing a range of potential outcomes and determining your comfort level with the risk/return proposition of each portfolio. You can then collaborate with your advisor to determine the most appropriate asset allocation strategy for you.

2 Expected risk/return reflects mathematical calculations based on historical data and is not indicative of future results.

Achieving Meaningful Diversification

Diversification is the foundation of portfolio management. Building on the idea that the whole of a portfolio is greater than the sum of its parts, you can reduce your portfolio's overall volatility by spreading investments across asset classes and within asset classes.[3]

First-Level Diversification: Across Asset Classes

The first level of diversification involves spreading your portfolio across the different asset classes. Strategically dividing your portfolio among stocks, bonds, cash, real estate, and alternative assets allows you to achieve a risk/return profile that is suitable for your goals and risk tolerance.

Each asset class has distinct risk/return characteristics and responds to market conditions differently. Combining these asset classes in an integrated portfolio disperses your risk exposure and return opportunities, which may reduce the overall volatility.

3 Diversification does not eliminate investment risk.

Through asset allocation, you can construct a portfolio that is designed to minimize risk for a targeted level of return.

EXHIBIT 1

Annualized Returns vs. Risk, Aug. 2007 - Jul. 2022

Investors generally must assume a greater level of risk to achieve greater return potential. This is demonstrated when looking at the annualized returns and the risk (as measured by standard deviation) for stocks, bonds, and U.S. Treasury bills. (See benchmark definitions and disclosures on the back page.)

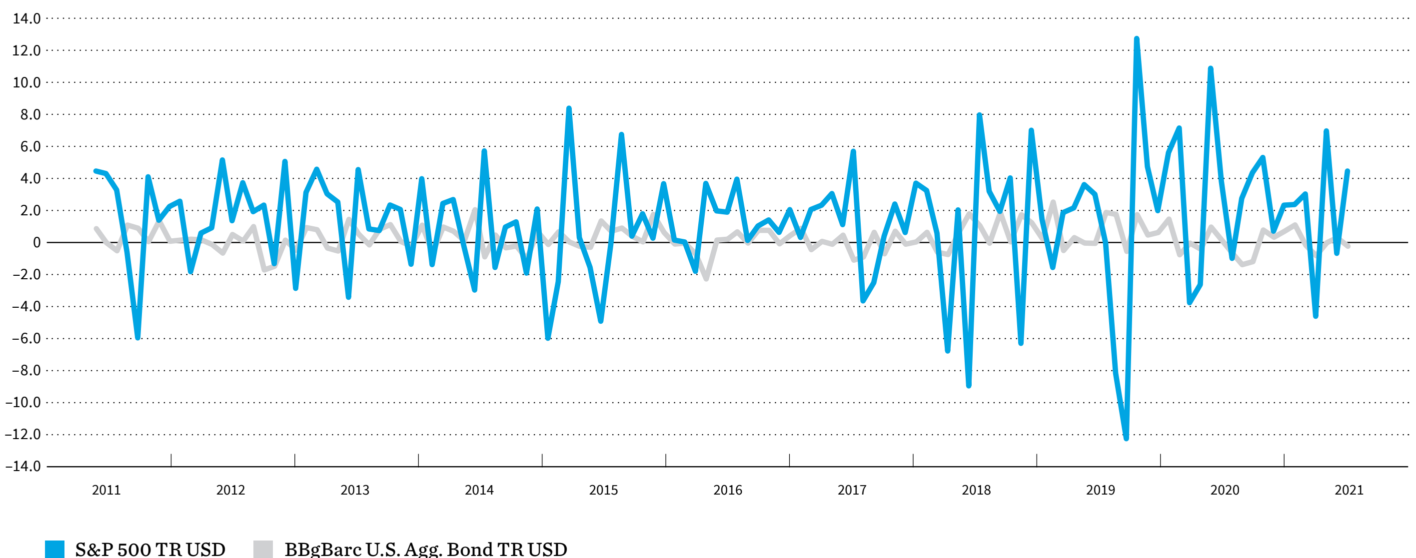
	S&P 500 Equities (%)	Barclays Aggregate Bonds (%)	30-Day Treasury Bills (%)
Risk	15.89	3.61	0.28
Return	9.41	3.37	0.62

Source: Morningstar Direct

EXHIBIT 2

Stocks vs. Bonds: Counterbalancing Risk

Bonds often become more attractive to investors—thus boosting prices—when the stock market is more volatile. This typically low or negative correlation relationship inverse relationship between fixed-income and equity markets can be a useful tool for counterbalancing risk in a portfolio.



Source: Morningstar Direct

Risk, in the context of investing, refers to the variability of asset or portfolio returns and the possibility that you could lose some, or all, of your principal. A common measure of risk is standard deviation—how much annual returns over a series of years vary from the average annual return during that period.

Generally, to potentially reap greater returns, you must be willing to accept a higher level of risk. FDIC-insured bank accounts, unlike investment advisory accounts (which are not insured) for example, may offer principal protection (up to the $250,000 per bank limit), but the returns historically have not kept up with inflation. Stocks, on the other hand, theoretically have unlimited upside potential, but principal is not safe from risk.

Bonds that pay interest can generate capital gains or losses if sold before maturity, and generally fall somewhere between cash and stocks on the risk/return spectrum. Macro risks such as changing interest rates can cause bond prices to rise or fall.

Second-Level Diversification: Within Asset Classes

Once you and your advisor have determined how to allocate assets across the various asset classes, it is time to implement the second level of diversification.

This level involves selecting an array of specific investments within each asset class. If the first level of diversification is determining the size of each basket (or the amount of money that you will invest in each asset class), then the second level is deciding exactly how to fill up each basket (i.e., which specific stocks will compose, for example, your equity asset allocation).

Diversification *within* asset classes helps reduce a portfolio's overall volatility by spreading the risk exposure and return opportunities across numerous investments:

- Equity diversification: investing in stocks of companies representing different industries, market capitalizations, investment styles (growth vs. value), and geographic regions
- Fixed-income diversification: investing in bonds of varying maturities, quality (credit ratings), and geographic regions

Even two portfolios with similar weightings of asset classes can vary in risk/return profile based on the selection of investments within each class. For example, two portfolios could have the exact same asset allocations across stocks and bonds, except that one's bond allocation comprises 20% high-yield bonds and 80% U.S. Treasuries while the other's allocation comprises 80% high-yield bonds and 20% Treasuries. The latter portfolio would likely have more upside potential and more volatility.

EXHIBIT 3

Equity Returns Across Regions: Annualized Risk/Return Characteristics, Jan 2002 - Dec. 2021

Investing across geographic regions can provide a valuable additional layer of diversification within a portfolio. The Sharpe Ratio looks at an investment's return relative to its risk (as measured by standard deviation). A higher Sharpe Ratio indicates better risk-adjusted performance. (See benchmark definitions and disclosures on the back page.)

Benchmark Index	Returns (%)	Standard Deviations(%)	Sharpe Ratio
MSCI EAFE	6.33	16.56	0.38
MSCI Emerging Markets	9.59	20.70	0.49
S&P 500	9.52	14.65	0.61

Source: Morningstar Direct

Choosing Investment Vehicles

In building a portfolio, you need to think about not only diversifying across and within asset classes, but also which types of investment vehicles to use. Each vehicle has distinct advantages and disadvantages in terms of customization, management fees, and tax consequences, and the choice of vehicles will play an integral role in your portfolio's ultimate success.

Individual stocks and bonds
Owning stocks or bonds directly is a common method to invest in securities. Direct ownership gives you control over which specific securities will be included in your portfolio, as well as control over the timing of transactions. This approach is research-intensive and carries commensurate management expenses, but it provides the most opportunities for customization, which can be especially beneficial for enhancing your portfolio's tax efficiency.

Separately managed accounts (SMAs)
SMAs are vehicles for professional management according to a stated strategy or philosophy. You directly own the securities held in the SMA, as opposed to a mutual fund, in which you own a share of the mutual fund's pooled assets. Because of the direct ownership of the securities, SMAs may offer some tax advantages relative to mutual funds, namely, the ability to offset gains with losses.

Mutual funds
By pooling investors' assets, mutual funds can provide a simple and relatively inexpensive way to achieve diversification and professional management within an asset class. This approach can be especially valuable if you do not have many assets to invest. Each fund has a specific strategy, which can be as broad as "all-cap growth" or as specific as "small-cap emerging-markets growth." You will not have any input on security selection or the timing of transactions within the fund, and you may be liable for income taxes resulting from the mutual fund's activity regardless of when you purchased the fund.

Exchange-traded funds (ETFs)
ETFs are shares of pooled-asset funds that are bought and sold on secondary markets. ETFs invest like mutual funds but trade like stocks. ETFs are designed to replicate the performance of an underlying index or sector and are a low-cost way for investors to get exposure to sectors, geographic regions, or asset classes.

Measuring Risk-Adjusted Returns

When measuring investment performance, it is important to look at returns in the context of how much risk was involved.

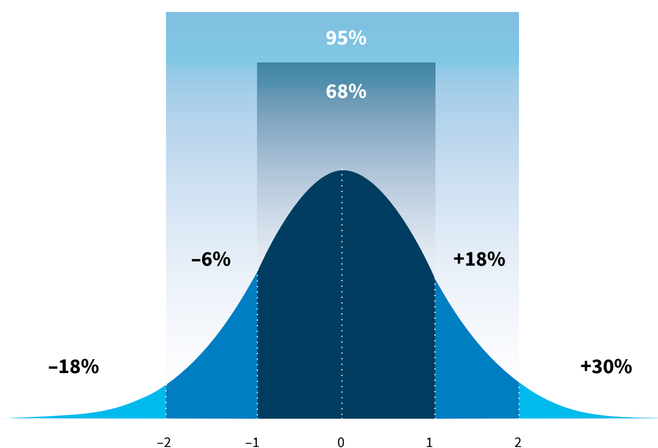
- Standard deviation measures how variable (or volatile) the returns are relative to the average return. The measure is calculated so that there is a 68% probability (based on historical data) that the return will be within one standard deviation of the average return. For example, if the average return is 6% and the standard deviation is 12%, there is a 68% probability that the return of that asset will be between –6% and +18%.

- Sharpe Ratio measures an asset's return relative to the amount of risk taken in the portfolio. It strives to identify how much return an investor should expect for every unit of risk taken. It is calculated by taking the return of the portfolio and subtracting the risk-free rate (the return that an investor could earn on a theoretically risk-free investment such as U.S. Treasury bills), then dividing this number by the standard deviation.

EXHIBIT 4

Standard Deviation

Standard deviation represents the range of likely outcomes around an average return. For example, if the average return is 6% and the standard deviation is 12%, there is a 68% probability that the return of that asset will be between –6% and +18%. Two standard deviations would capture 95% of likely outcomes and in this example would represent a range from –18% to +30%.



Standard Deviation: 12%
Average Return: 6%

Monitoring Your Allocations and Reviewing Your Plan

Monitoring Your Allocations

Implementation of your asset allocation strategy is not the last step. Strategic asset allocation is an ongoing process. Your allocations must be closely monitored and your overall plan regularly reviewed to adapt to dynamic market conditions, tax law changes, and changes in your goals and circumstances.

Significant life events, such as marriage or the birth of children, can affect your goals and risk tolerance. Your portfolio should reflect these changes as well as the natural time-horizon shift that occurs as you approach your goals.

Schedule a Portfolio Review

William Blair invites you to contact us to schedule a time to review your portfolio. By reviewing your assets managed at William Blair as well as your outside assets, we will provide a comprehensive analysis of potential vulnerabilities and opportunities to realign your portfolio with your wealth objectives and evolving market conditions. A portfolio review with William Blair will analyze:

- Asset allocation across asset classes, sectors, and geographic regions
- Risk exposure to macroeconomic and market forces
- Alignment of asset allocation with retirement and wealth-transfer goals that are relevant to investors after reaching age 70 ½ to take advantage of the additional 1 ½-year window

To ensure your financial planning objectives are met and to discuss how the new rules apply to your plan, please contact your William Blair wealth advisor.

Benchmark Index Descriptions and Disclosures

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of 26 developing economies including Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and the United Arab Emirates.The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada.

The MSCI EAFE Index is an equity index which captures large and mid cap representation across 21 Developed Markets countries* around the world, excluding the US and Canada. Developed Markets countries in the MSCI EAFE Index include: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The Standard & Poor's 500 is an index of 500 stocks chosen for market size, liquidity, and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large-cap universe. Companies included in the index are selected by the S&P Index Committee, a team of analysts and economists at Standard & Poor's. The S&P 500 is a market value weighted index; each stock's weight is proportionate to its market value. Barclays Aggregate Bond is a broad bond index consisting of government, corporate, mortgage-backed, and asset-backed securities that are rated investment grade (BBB) or higher, have at least one year to maturity, have outstanding par value of at least $100 million and are dollar-denominated and nonconvertible.

The Federal Reserve 3-Month Treasury Bill index (Secondary Market) is based on the active resale or secondary market in Treasury bills that centers around dealers, both commercial banks and non-bank dealers, that report daily activity to the Federal Reserve Bank of New York.

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Past performance is not an indicator or guarantee of future results. An index is unmanaged and does not incur fees or expenses. An investment cannot be made directly into an index.

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